AQA
Realising potential

# A-LEVEL ACCOUNTING

A-level (7127)

# EXAMPLE RESPONSES

**Marked responses**
7127 Paper 2 7127/2: 16 and 17

See responses to 25-mark questions to show how different levels are achieved and understand how to interpret the mark scheme.


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# Contents

Please note that these responses have been reproduced exactly as they were written and have not been subject to the usual standardisation process.

# Specimen paper 2, question 16

## Question

Stancost Ltd manufacture high quality wooden furniture for homes and offices. The company operates a standard costing system.

The managing director is very concerned that the actual profit for the month at £22 770 is significantly less than the budgeted profit of £90 000.

The cost accountant provides the following information.

| | Budget | | Actual | |
|---|---|---|---|---|
| Sales and production | 800 tables | £650 per table | 860 tables | £600 per table |
| Materials | 25 metres per table | £5.50 per metre | 35 metres per table | £4.50 per metre |
| Labour | 15 hours per table | £20 per hour | 19 hours per table | £17 per hour |

The cost accountant has also calculated the relevant variances.

The managers of the relevant departments have seen the figures above and have made some initial comments.

Manager responsible for sales.
"The price variance was the result of having to lower the price because of increased competition."

Manager responsible for materials.
"The price variance was the result of negotiating a much better deal with a new supplier."

Manager responsible for labour
"We have followed other companies in the industry and employed workers on zero hour contracts and this has reduced our wage bill."

The Managing Director believes that the managers may be covering for each other and the reasons given are not the real causes of the variances but have been caused internally.

Assess the significance of the variances on the performance of the business and the Managing Director's view that the variances are caused internally.

**[25 marks]**

## Mark scheme

AO2 – 5 marks, AO3 – 20 marks

| Level | Marks | Des |
|---|---|---|
| **5** | **21–25** | A clear and balanced response that presents a coherent and logically reasoned judgement and conclusion/solution that is supported by an astute consideration of a wide range of evidence including other factors relevant to the wider context.<br><br>There is an insightful assessment of the significance and limitations of the evidence used to support the judgement. |
| **4** | **16–20** | A reasoned, but in places unbalanced, judgement and conclusion/solution is presented that is supported by an evaluation of a wide range of evidence, including a narrow consideration of other factors relevant to the wider context.<br><br>There is a partial assessment of the significance and limitations of the evidence used to support the judgement. |
| **3** | **11–15** | An underdeveloped judgement and conclusion/solution is presented that is supported by an evaluation of a range of evidence provided in the question; however there may be inconsistencies and the reasoning may contain inaccuracies.<br><br>A comprehensive and relevant selection of information is analysed, showing a developed logical chain of reasoning. The results of any appropriate calculation/s are integrated into the analysis and evaluations offered on most.<br><br>Comprehensive and relevant knowledge and understanding of principles/concepts/techniques is drawn together and applied successfully to the context. Where appropriate, a thorough selection of relevant calculations is |
| **2** | **6–10** | A basic judgement and conclusion/solution is presented, it is supported by a limited evaluation of evidence provided in the question, containing significant inaccuracies.<br><br>A limited but relevant selection of information is analysed, starting to develop a logical chain of reasoning. The results of the calculation/s are integrated into the analysis but with weak evaluations.<br><br>Limited but relevant knowledge and understanding of principles/concepts/techniques is drawn together and applied successfully to |
| **1** | **1–5** | A judgement and conclusion/solution may be asserted, but it is unsupported by any evidence.<br><br>Responses present a limited selection of information that is not wholly relevant with an attempt at analysis. A chain of reasoning ranges from being barely present to undeveloped.<br><br>Fragmented items of knowledge and understanding of principles/concepts/techniques relevant to the contexts are present. These are likely to be descriptive, with limited application to the context. Where appropriate, some calculations are attempted; these are likely to contain errors and may not |
| **0** | **0** | Nothing written worthy of credit. |

Answers may include:

**AO2 - Application**

Reference to the size and direction of the variances for example:
All departments produce overall adverse variances.

Total variances are:
Sales 43 000 – 39 000 = 4000 adverse
Materials 47 300 – 30 100 = 17 200 adverse
Labour 68 800 – 49 020 = 19 780 adverse

Alternatively, this could be presented as a reconciliation for
Example:

| **Reconciliation** | | £ |
|---|---|---|
| Actual profit | | 22 770 |
| Contribution adjustment | | (12 750) |
| | | 10 020 |
| Material price | (30 100) | |
| Material usage | 47 300 | |
| Labour rate | (49 020) | |
| Labour efficiency | 68 000 | |
| Sales price | 43 000 | |
| | | 79 980 |
| Budgeted profit | | 90 000 |

Suggest possible causes for the variances given for example:
Possible causes other than those given in the question

Materials
- Price – poor quality materials
  Increased competition in the markets causing a price reduction
- Usage – poor quality material causing increased wastage

Labour
- Rate – employing less skilled workers at a lower rate of pay
  A fall in the market wages
- Efficiency – less skilled workers taking longer to complete the tasks

Sales
- Price – reduction in price to undercut the opposition or move slow moving products
  Price reduced because product is of poor quality
- Volume – The price reduction resulted in increased sales
  Reduced competition in the market

**AO3 – Analysis and Evaluation**

**Assessing of significance of the variances**
The labour department produces the largest overall variance.
The labour department also has the largest sub-variances eg the favourable variance is £49 020 compared to sales with £43 000 and materials with £30 100.
The adverse variance is significantly higher than the other two at £68 800 which is over £20 000 higher than the next largest variance at £47 300.

**Interrelationship of the variances**
Students would be expected to identify the potential links between the variances other than those given above, for example.
The material usage variance could be caused by less skilled workers that have resulted in the adverse efficiency variance.
The labour efficiency variance could be caused by poor quality materials that have resulted in the materials price and usage variances.
The sales price variance could be caused by a poor quality product which is the result of poor materials and a less skilled workforce.

**Overall assessment**
External factors that could cause variances such as:
Materials – price fall due to market change
Labour – lack of skilled workers nationally
Sales – increased competition from abroad
Other valid reasons should be accepted
Not enough information to decide causes
Are original standards correct?

**Note: Not all content needs to be covered to gain full marks.**

The indicative content is not exhaustive; other creditworthy material should be awarded marks as appropriate.

## Student responses

### Student response 1

The materials price variance is favourable meaning that we are paying less for materials than anticipated. The reason given is that they got a better deal with a new supplier. However, the material usage variance is adverse, meaning that much more material is being consumed than anticipated. One likely reason for this is that the new supplier is providing cheaper materials which are at a lower quality, and that the workers are struggling with the poorer materials resulting in more wastage and a lower quality end product.

A lower quality product could be the reason behind the adverse sales price variance. This could be because the managers are having to sell the product at a lower price due to the lower quality. Alternatively, though the lower selling price could be due to the increased competition as suggested, or because the budgeted selling price was overestimated and they were struggling to sell the tables for £650.

Labour rate has a favourable variance and the managers say this is because they now employ their workers on zero hour contracts. This means they don't have to pay workers for hours they don't work thus saving significantly on wages. However, at the same time labour efficiency has got a very large adverse variance. This adverse variance is most likely linked to the workers being on zero hour contracts. Employing workers on these contracts has likely caused a decrease in staff morale causing skilled workers to leave and be replaced with lower quality workers. This is likely also to be linked to the adverse materials usage variance because the lower skilled workers will waste much more of the lower quality materials than the skilled workers would have.

In conclusion, there are more adverse variances than there are favourable, and most of those which are favourable are likely to be causing negative results, such as, saving on the price of materials, but as a result having poorer quality materials. The Managing Director is probably correct in his claim that the variances are caused internally because as explained in the above paragraphs, the variances can be linked together and potential causes can be identified. For example, lower sales price due to lower quality product which arises from cheap materials and unskilled lower paid labour.

**This is a level 2 response.**

The question asked for an assessment of the significance of the variances but none was provided. There is some basic judgement, however, there was limited use of evidence and a limited selection of relevant information. Some logical chain of reasoning present. It does recognise the interrelationship of variances but does not use the values given to generate some assessment of significance.

## Student response 2

| Profit reconciliation | £ |
|---|---|
| Budgeted profit | 90,000 |
| Add favourable | |
| Sales volume | 12,750 |
| Materials price | 30,100 |
| Labour rate | 49,020 |
| Less adverse | |
| Sales price | (43,000) |
| Materials usage | (47,300) |
| Labour efficiency | (68,800) |
| Actual profit | 22,770 |

Budgeted contribution:
£650 - ((25 x 5.5) + (15 x 20)) = £212.50
£212.50 x 60 = £12,750

A variance is the difference between what is expected to happen and what actually happened.

The sales price variances may have occurred because to sell more the sales price had to be lowered. The price that was expected to be charged was £650 but the actual sales price was £600. This lower price resulted in 60 extra tables being sold, which gave £39,000 favourable sales volume at the expense of a lower price which gave an adverse sales price variance of £43,000. This would show a net adverse position of £4,000 however, when the extra variable costs are considered it is even worse. The net benefit of the extra sales volume is only £12,750 so overall Stancost Ltd has a net adverse position of £30,250. This suggests that the variance has been caused internally, however it is also possible the pressure to lower prices might have been caused by competition as stated by the manager responsible. But if this competition was expected then the managers should have budgeted for this, so it raises the question of whether the forecasts are reliable.

The materials variances may have been caused because of negotiating better prices with suppliers. This would lower the cost of the materials which has led to a favourable material price variance. However, the lower priced materials may not be of high quality so a lot more must be used to produce the output. Buying cheaper materials may therefore be a false economy as the business is a net £17200 worse off as a result.

The labour variances show that the labour rate is favourable but the efficiency is adverse. A net adverse difference of £19780. This may be caused by zero hour contracts. Workers are only being paid when they have work to do. This may reduce costs but can act as a disincentive for workers as overall, they may be paid less than before. This can reduce productivity which then causes efficiency to fall which has resulted in an adverse variance. The lower pay may mean skilled workers are deterred from working for Stancost Ltd so the firm is left with lower skilled workers. This means they may be less efficient as they don't have the skills or they have not been trained well enough or at all. This means they are less productive and less efficient.

All the variances interlink with each other. The lower wages for workers may result in low skilled workers producing at a less efficient level which causes the efficiency variance. This can cause a wastage of materials because the low skilled workers may make mistakes or must use a lot more materials to produce a table. This coupled with the poor quality material, due to the lower price, could mean there is a lot more wastage and less efficiency in output. Efficiency for labour is the most significant variance at £68,000 adverse. This shows that there is a lack of skilled labour and training so workers may not be trained on how to produce output in an efficient way that saves materials. Because of the lower cost of materials and labour the firm can afford to lower the selling price to be competitive which results in more being sold.

Overall, I think that the variances have been caused internally but there are external effects that have caused some variances to a certain extent. The figures may need to be investigated further to come to a full conclusion.

**This is a level 4 response.**

This answer does assess the significance of the variances. The judgement does need more development but is showing signs of being reasonable if a little unbalanced. It considers a wide range of evidence although reference could have made to the reconciliation provided at the beginning. Contains a partial assessment of the significance and limitations of the evidence, and displays good knowledge and understanding applied to the context.

### Student response 3

The managing director is correct to be concerned as the actual monthly profit of £22,770 is significantly below the budgeted profit of £90,000. A difference of £67,230 which if repeated every month would be £806,760 shortfall for the year. This could be the difference between success or failure for Stancost Ltd.

Standard costing is based on the concept of responsibility accounting. By planning what the income and costs should be under normal working conditions Stancost Ltd can identify where there are problems and then investigate so that solutions can be put in place. This is done by calculating variances which are the differences between the actual outcome and a flexed plan. An adverse variance would mean profit will be lower, and a favourable variance would mean profit will be higher.

The sales manager has blamed external competition for the lower selling price. The price was dropped and this has caused an adverse sales price variance of £43,000. The explanation seems reasonable but why was this competition not anticipated and planned for when the plan was produced, e.g. additional advertising or special deals for major customers. A failure to anticipate this problem would be an internal cause. The lower price did result in more units being sold which generated a £39,000 favourable sales volume variance. However, this sales volume variance does not generate additional profit of £39,000 because the extra units incur additional material and labour costs. The net benefit of the extra units is only £12,750 ((25 x £5.50) + (15 x £20) = £437.50 – 650 = 212.50 x 60 = 12750). Therefore, overall the sales manager is responsible for £43,000 – 12,750 = £30,250 drop in profit, which is almost half of the total fall.

In fairness, it may not all be the fault of the sales manager as the other managers may also be responsible. For example, the purchasing manager has switched supplier to get a lower price. This resulted in a £30,100 favourable material price variance which should be good news. However, the new supplier may not be able to match the quality of the previous supplier and this may cause material to be scrapped, hence an adverse material usage variance of £47,300. The new supplier may not be able to deliver on time and as a result employees have been standing idle waiting for the materials to arrive. This could have caused the adverse labour efficiency variance of £68,800. When an issue in one area results in a knock-on problem in another area this is called the interrelationship of variances.

In my opinion it is difficult to come to a firm conclusion as to whether it is internal or external problems that are causing the variances for Stancost Ltd. What they will need to do is investigate more fully what the causes are because the information we have is very limited. However, there does seem to be a number of conflicting issues, for example, a favourable labour rate variance of £49,020 means they are paying their employees less than they anticipated but this could be bad news if the employees are not working as efficiently as planned as shown by adverse labour efficiency and material usage variances totalling £116,100. In all probability, it is likely to be a mix of internal and external factors. Externally, competitors may be changing their tactics to win more market share, or suppliers may be altering their products to lower costs. Internally, the standards could have been set incorrectly in the planning stage, or managers are acting in their own best interests rather than considering the full consequences of their actions on the company as a whole. More investigation is required.

The reconciliation below shows how the variances have affected the budgeted profit:

Budgeted profit (860 x £212.50) = £182,750
Add favourable variances = £79,120
Less adverse variances = £159,100
Actual profit = £102,770

Other costs/overheads £80,000?

**This is a level 4 response.**

This answer does assess the significance of the variances. The judgement is reasoned but is a little unbalanced. It considers a wide range of evidence, although the reconciliation provided at the end is not presented very clearly. Contains a partial assessment of the significance and limitations of the evidence, and displays good knowledge and understanding applied to the context.

# Specimen paper 2, question 17

## Question

The directors of Londro plc, a large holding company, are considering two alternative investment projects. Whichever project is chosen, the company will have to borrow the initial investment at a variable interest rate of 4% per annum

**Project A**
This project involves the exploitation of mineral resources in an under-developed country. The resources would provide cheap raw materials for other companies in the Londro group. It will result in large numbers of local workers being employed on low skilled jobs, bringing a boost to the country's economy.

**Project B**
This project is to build a shopping and leisure complex on ex-industrial land in the North of England. The land is available due to the closure of the steel works which was the main employer in the area. The complex would provide significant job opportunities in the retail and leisure sector.

The Finance Director has carried out investment appraisals on both projects and this is summarised below

| | **Project A** | **Project B** |
|---|---|---|
| Initial investment | £80 million | £50 million |
| Net present value | £950 000 | £650 000 |
| Payback period | 10 years | 15 years |
| Estimated life of project | 15 years | 25 years |

Net present value was calculated using a discount rate of 9% for both projects. This was based on the current return on capital employed of 5% plus the interest rate of 4%.

Assess the **two** projects and recommend to the directors the one they should select.

**[25 marks]**

## Mark scheme

AO2 – 5 marks, AO3 – 20 marks

| Level | Marks | Des |
|---|---|---|
| **5** | **21–25** | A clear and balanced response that presents a coherent and logically reasoned judgement and conclusion/solution that is supported by an astute consideration of a wide range of evidence including other factors relevant to the wider context.<br><br>There is an insightful assessment of the significance and limitations of the evidence used to support the judgement. |
| **4** | **16–20** | A reasoned, but in places unbalanced, judgement and conclusion/solution is presented that is supported by an evaluation of a wide range of evidence, including a narrow consideration of other factors relevant to the wider context.<br><br>There is a partial assessment of the significance and limitations of the evidence used to support the judgement. |
| **3** | **11–15** | An underdeveloped judgement and conclusion/solution is presented that is supported by an evaluation of a range of evidence provided in the question; however there may be inconsistencies and the reasoning may contain inaccuracies.<br><br>A comprehensive and relevant selection of information is analysed, showing a developed logical chain of reasoning. The results of any appropriate calculation/s are integrated into the analysis and evaluations offered on most.<br><br>Comprehensive and relevant knowledge and understanding of principles/concepts/techniques is drawn together and applied successfully to the context. Where appropriate, a thorough selection of relevant calculations is |
| **2** | **6–10** | A basic judgement and conclusion/solution is presented, it is supported by a limited evaluation of evidence provided in the question, containing significant inaccuracies.<br><br>A limited but relevant selection of information is analysed, starting to develop a logical chain of reasoning. The results of the calculation/s are integrated into the analysis but with weak evaluations.<br><br>Limited but relevant knowledge and understanding of principles/concepts/techniques is drawn together and applied successfully to |
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| **0** | **0** | Nothing written worthy of credit. |

**Answers may include:**

| **AO2 – Application** |
|---|
| **Comparing the financial data for the two projects**<br><br>Project A : Payback is quicker (5 years) and NPV higher (by £350 000)<br>Life of project A is shorter (by 10 years) and closer to payback so B may produce more in cash flow after payback period<br><br>**Relating non-financial factors to the scenario:**<br><br>Project A<br>Impact on environment<br>Exploitation of scarce resources<br><br>Project B<br>Impact on local environment – could be positive eg using derelict land<br>Impact on local economy and unemployment |
| **AO3 – Analysis and Evaluation** |
| **Analysis of the financial data**<br>Decision may depend on discount factor – interest rates are variable and ROCE may change – sensible to conduct sensitivity analysis on the data.<br>Size of initial investment should be considered – will funds be available?<br>How reliable are cash flows etc 15–25 years in the future?<br><br>**Other factors to consider/evaluate**<br>Project A<br>Is fair price being paid or are resources used to subsidise other areas of the business<br>Impact on employment in under developed country – is this good or bad – possible exploitation of local workforce v opportunities for employment and increased living standards<br><br>Project B<br>Impact on local environment – could be positive ag using derelict land, however there may be negative impacts from for example increased traffic – there may be more environmentally friendly alternatives<br>Will unemployed have skills/attitudes to take jobs created?<br><br>**Overall**<br>How reliable is the data used in the calculations?<br>What guarantee that either project will be successful? |

**Note: Not all content needs to be covered to gain full marks.**

The indicative content is not exhaustive; other creditworthy material should be awarded marks as appropriate.

## Student responses

### Student response 4

Both projects have a variable interest rate. For project A, the initial investment is £80 million whereas for project B it is £50 million. We will be paying more interest with project A whatever the variable interest rate is. This is bad news. A payback period is the time it taken for money that we borrowed to be paid back. Project A has a faster payback period than B which means if everything else were to remain fixed, project A would generate more profits than B. The payback is shorter by 5 years although the investment is larger. However, project B lasts for 10 years longer which means it may or may not have the same total profit for the company. We would need to make forecasts to be able to compare.

The NPV for project A is £950,000 in comparison to the NPV of project B which is £650,000. This is £300,000 more which increases the value of the business quite considerably. Both increase the value of Londro but project A increases it by £300,000 more and so should be chosen. However, the discount factor may not be valid as the interest is variable and not constant at 4%, so the NPV's given are not very accurate or reliable. If the interest rates were to rise then the discount factor used would have to be increased, and a higher discount factor would mean the final NPV would be smaller and may even become negative. A project with a negative NPV should be rejected because it lowers the value of the business.

If for example, we take only the profits of each project to pay back the investment, an £80 million investment which has a payback of 10 years, means each year we generate £8 million in profits. This has an estimated life of 5 years after the payback which means net profits of £40 million. If the same is done for project B, this indicates net profits of £33 million over its life which is less than that of project A by £7 million. Therefore, from a profit point of view Londro should choose project A.

With project A, we must 'exploit' the Earth's finite resources which is not good for sustainability. The fact we're looking for other means to obtain these minerals rather than going to a company in the Londro group may cause conflict. Both project A and B provide job opportunities. A in a LEDC and B in England. For A, it will be cheap labour but this will help boost the country's economy. For B, it will help people get more professional jobs. However, B is being made where there was a steel works company before, so the area may not be safe and there may not be many people looking for jobs in retail or leisure. Also, the fact that it's in an ex-industrial location means that the geographical positioning of this company is not ideal for its purposes. The footfall could be higher somewhere else.

All in all, I recommend project A as it has a higher NPV and shorter payback period which concludes it's the more profitable option.

**This is a level 2 response.**

Basic judgement provided which is supported by a limited evaluation of the evidence in the question. However, it does display good knowledge and evidence of reasoning when questioning the logic behind the selection of the discount factor used in the NPV calculation. Limited selection of information with some calculations.

## Student response 5

One non-financial factor that the directors should consider for both projects is their corporate social image.

Project A involves the exploitation of scarce resources in a less economically developed country. This could be damaging to the image of Londro plc as it can damage the environment. This may result in serious implications for the firm; if consumers and potential investors find out then they may not want to buy goods and services from the firm which can lead to a fall in sales and overall profitability. As the firm is a plc, the share price may fall in value if potential investors don't want to invest in a firm that has a negative social image. This can lead to a lack of investment from shareholders in the long run. Also, the firm may face opposition from environmental groups which again would tarnish the image of the company. However, the extent to which the negative image will cause sales and share prices to actually fall is arguable. The resources are cheap which means the cost of production will be lower and this may mean the firm can lower prices which in turn encourages demand. The profits from this may look attractive to shareholders and encourage investment, which may cause the share price to rise. In the short run, the firm may face implications as a result of the exploitation of resources, but in the long run they will benefit from lower costs of production and higher profits, even if it is ethically wrong.

Although, project A will create more jobs which is beneficial to the economy, as it means unemployment falls which will boost the economy. However, the jobs created will be low skilled which may imply that they are low paid. This will reduce or help keep costs low for the firm and as a result profits may rise. It may also help with their image as they will be a large local employer so Londro plc can retain their social image.

In comparison, project B may not have as many environmental effects. Building a new shopping area will create more jobs in the manufacturing industry as well as in the retail sector. Modern retail parks use building materials that are made in factories so they can be installed quickly. Whilst project A creates local employment, project B will create jobs on a larger geographical scale and will boost jobs in the sector. If the sector experiences a boost this can increase competitiveness of retail firms which will lead to higher profitability, increased productivity and will eventually boost the economy by providing significant jobs opportunities. The project is also expected to last 25 years so this means it will have a long run effect on the economy and can improve their corporate social image. This may boost the value of the shares and encourage investment into Londro plc.

There are also financial considerations for both projects. Project A requires £80 million initial investment. This will mean the firm will have to borrow a large amount which increases gearing significantly. If gearing rises, the risk exposure of the firm increases which may mean the share price falls as people will not want to invest if the financial risks are too high. The cost of capital each year will be 4% at a variable rate of the initial finance which is around £3.2 million a year. However, the payback period is 10 years and the life of the project is 15 years. This means that it will take 10 years to receive all the benefits and pay back the cost of the project. 5 years will be all the extra benefits from the project and at the end of the life of the project the net present value will be £950,000. This is beneficial to the firm as they will pay back the cost within 10 years and will have an extra 5 years on top to gain additional benefits. However, the reliability of the data can be questioned. The discount factor may be inaccurate and so the net present value of the investment may not be representative. Also, a payback of 10 years will mean that the firm will have a substantial amount of working capital and it is important to look at the net cash flows of the firm.

In comparison, project B requires a lower investment amount of £50 million which means that the gearing will be lower compared to project A. However, it has a lower net present value by £300,000 and the payback is longer. This means that the amount they have to pay back in interest can rise or fall significantly over the years as the interest rate is variable. Although the life of the project is 25 years so they have an extra 10 years to receive all the benefits of the project. Again the reliability of the data can be questioned and the net present value may not allow for the chance that extra interest may have to be paid.

An additional point to consider is where will the finance come from? If it is a debenture then security is required similar to a bank loan and we are not told if Londro has sufficient security for this size of loan. We also do not know just how much debt they have at present. It may be that trying to raise an extra £30 million may be too much and so they may not be able to choose project A.

Overall, I recommend project B because it is not as damaging to the environment compared to project A and less investment is required which means there is lower gearing for the firm. Also, investing overseas may not be a good idea. We do not know where in the world project A may be located and it may be too risky to invest in that country, for example, there may be the chance that a civil war may start and any investment may be lost. Therefore, as project B is in the UK I would again say this is my recommendation.

**This is a level 3 response.**

A reasoned but slightly unbalanced judgement produced after consideration of a range of evidence. Included, is a partial assessment of the significance and limitations of the evidence used. Logical chains of reasoning present, however, there is limited knowledge and understanding applied to the context. There is a lot of thought given to the non-financial factors involved in this decision.

## Student response 6

Project A will cost £30 million more than B, but will have a 5-year quicker payback period (the time it takes to payback the initial investment cost of the project). This is good because the quicker the payback period, the quicker Londro plc can start to invest in other projects it may have in the pipe-line. The net present value is also £300,000 higher, meaning it will be worth more to the shareholders, which in turn could result in them being more flexible to invest in shares or delay dividend payments as they know their money is being put to good use. The fact that local workers will be employed means that the company will be praised for the benefits of this project, helping to produce positive press coverage. Since it is also in an under-developed country, boosting the country's economy can have further positive implications, which could lead to better relationships with potential suppliers or customers in the region. The most beneficial factor in this project is the fact it can help other companies in the holding group, which could improve profitability and liquidity across Londro plc.

However, the exploitation of mineral resources could prove to be costly and result in bad public relations since the local environment could be damaged significantly. This in turn may lead to some customers of Londro plc refusing to continue trading due to moral reasons. Also, local workers will not have many qualifications or skills after the 15 years, so this may only be a short-term boost in the economy, only to fall again. As well as this, mining can be very dangerous, meaning local workers may be at risk, since safety regulations in under-developed countries can be very poor. If there were lots of accidents then Londro plc may be blamed for this. They could be labelled as unethical which again would result in bad publicity and could have financial implications. The value of the project after taking into consideration the cost of capital (the return shareholders could make if they invested elsewhere) is only £300,000 higher for an extra cost of £30 million, which may mean that although it generates more money in total, it may not be worth the risk.

Project B is the longest project at 25 years, and will take 5 years longer to pay back the initial investment of £50 million. The longevity of this project may prove beneficial as it means the job opportunities will last longer; helping the local people (who may have been made redundant after the closure of the steel works) move on and gain more experience in a different job sector. This means they can learn new skills, in turn generating positive feelings towards the project and its social impacts.

On the other hand, the project can also prove to be costly, as the old industrial land will probably have been polluted and may need to have special/expensive treatment so that it fits safety regulations (which are harsher in the UK than overseas). If these costs have not been included in the financial analysis then both the payback and the £650,000 NPV may be optimistic. The location can also have an impact, as this project relies on customers travelling to the retail park which can change with the economy and wealth of the area. Whereas, demand for mineral resources (project A) can be more reliable as there is a global demand for resources and they can be shipped round the world. The retail park will be limited to a more local market.

In my opinion, I would choose project B as I believe it is less risky for the company as a whole. Since the interest rate they will borrow at is variable it may be beneficial to borrow less. Borrowing the larger sum could expose Londro plc to more profit/cash flow problems if the interest rates were to rise. This may outweigh the gains if the rate was to fall. Although project A may seem a better financial option, the cost of capital (the return shareholders could make if they invested elsewhere) will fluctuate with a variable interest rate, so the 9% NPV calculation could prove to be unreliable. I also believe that the fact project A will also damage the environment and result in bad press for the company will outweigh the financial benefits. This would lead to the share price falling (meaning shareholders will be unhappy) and restrictions caused by ever changing global regulations (e.g. climate change/preservation laws, etc.) would result in unpredictable problems.

**This is a level 3 response.**

A reasoned but slightly unbalanced judgement produced after consideration of a range of evidence. Included, is a partial assessment of the significance and limitations of the evidence used. Logical chains of reasoning present, however, there is limited knowledge and understanding applied to the context. There is a lot of thought given to the non-financial factors involved in this decision.

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