

CCEA A2 UNIT 2 STUDENT GUIDE

CCEA

Business Studies

The competitive business environment

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Content Guidance

■ Macroeconomic framework

A **macroeconomic** framework sets the general economic framework, which a government adopts in relation to the management of the economy. Governments use macroeconomic models to help formulate strategies on economic policies such as growth, sustainable development, inflation, unemployment and balance of payments.

Role of enterprise in resource allocation

Society faces the problem of how to make the best use of limited, scarce and finite resources. Governments need to balance the unlimited needs and wants of their citizens against the limited resources available to satisfy those needs. Limited resources include those limited in:

- physical quantity, especially land, which is essentially finite
- use, especially the four factors of production (land, labour, capital and enterprise), which can only be used for one purpose at any given time

Economic systems

An economic system determines who has the most control over the country's scarce resources. There are three types of economic systems that operate across the world.

Free market economy

A free market economy is one in which resource application is determined through the price mechanism, or demand and supply analysis. There is little intervention by government, if only to protect consumers, but by and large the economy is left to the determinants of the market place, demand and supply. The markets resolve the scarce resources issues by themselves, while businesses and consumers determine what resources are allocated. However, in reality, no market is a totally free market economy — all economies must abide by constraints imposed on them through government regulations.

Therefore, free market economies tend to be freer in countries that promote capitalism.

Planned/command economy

In a planned economy the government allocates the scarce resources it owns and controls. The government decides on the needs of the population and allocates the scarce resources accordingly to achieve those needs. This may require setting production levels for all factories and setting food targets, education needs and skills required to achieve the government's objectives. The government determines prices — prices do not play a part in resource allocation.

Macroeconomics

The study of economic behaviour and the performance of a national economy, for example the UK economy.

Exam tip

You can enhance your understanding of issues affecting businesses, such as changes in base interest rates, inflation rates and economic growth rates, by gaining a good understanding of key aspects of the UK and Northern Ireland economies.

Communist countries are prime examples of a planned economy, since communist governments control all decisions regarding the factors of production.

Mixed economy

A mixed economy is one in which a combination of both government (public sector) and businesses (private sector) own the scarce resources. The markets determine price in the free market part of this economy, while other parts of the same economy are left to the government to operate. Examples of government intervention include providing health, education, security, welfare and state pensions.

Of all three economies the mixed economy is the most prevalent. The level of government intervention varies in these types of economy. For example, the share of government spending as a percentage of GDP in the UK is approximately 47%.

The advantages of a mixed economy include the following:

- There is little government intervention, which ensures greater opportunities for entrepreneurship.
- There are incentives for businesses to be more efficient in the private sector as it is their profits at stake.
- There is a reduction in market failure through government interventions that protect fair competition.
- A mixed economy offers a degree of equality, as the employed receive their awards for working while the government funds the unemployed who are protected in a safety net against poverty.
- There is macroeconomic stability, as the government intervenes in the market to assist businesses with employment issues during a recession and invests national insurance monies, releasing funds to businesses to further invest.
- Free markets opposed to government intervention agree that government intervention is appropriate in cases where the free market is unable to manage effectively, including in education and law and order.

The disadvantages of a mixed economy include the following:

- Government intervention policies such as increasing bank interest rates increase prices, which affects the demand and supply of goods in the private sector.
- Socialists want even more government intervention to protect them from the excesses of the free market.
- Fewer government controls on the market could lead to issues such as businesses engaging in bribery and corruption to achieve maximum profits.
- Too much government intervention has caused business failures in the private sector in the past. For example, in the restaurant market, some restaurants were forced to close due to their inability to build smoke-free areas after the introduction of the ban on smoking.
- Politicians and civil servants are poor managers of scarce resources in the government and their decisions are not always built on sound economics but political motivations.

In conclusion, both business and government play important roles in the distribution of scarce resources in a mixed economy.

A mixed economy has a number of characteristics, including the following:

- Production of goods and services are mainly under private ownership, i.e. sole traders, partnerships, limited companies, social enterprises, and both the charitable and the voluntary sector.
- Markets remain the dominant form of economic coordination.
- Profit-seeking businesses and the accumulation of capital wealth remains the fundamental driving force behind economic activity.
- However, the government has considerable influence over the economy and intervenes when required.

Social enterprises

A social enterprise is a business that trades to make maximised profits and which reinvests all or some of those profits into solving societal needs, especially those from at-risk sections of the community. Its social objectives include tackling social problems in the local community, improving people's life chances, supporting the local community and helping the environment.

Social enterprise businesses include coffee shops, public houses, restaurants, cinemas, banks and bus companies. They trade independently and profits are earned through normal trading activities.

The benefits of social enterprises include the following:

- They provide employment to the local community, enabling community members to earn income.
- They create positive change in local communities.
- They provide a source of income other than donations or grants for community needs.
- They reduce reliance on government and other traditional funding sources.
- The community can request funds for specific targeted needs and the social enterprise can respond immediately.
- They expand on community services that meet emerging needs.
- Trading activities give the social enterprise a competitive edge.

The limitations of social enterprises include the following:

- As a normal trading business, social enterprises are faced with the same economic conditions common to all businesses and can therefore make losses.
- Social enterprises must charge competitive prices in order to make profits.
- Managing the culture within a social enterprise that has maximised profit as its main objective is extremely difficult.
- Not all profits a social enterprise makes can go to the local community. Some profits must be retained for capital investment.
- Social enterprises are unable to look for additional funding from other sources, as funders view the social enterprises themselves as funders.

Charities

Charities are set up to provide help and raise money for those who are disadvantaged in society. Application for charitable status is made to the Charity Commission, which decides whether an organisation is a charity that can pass certain regulations.

Knowledge check 1

Explain the term 'mixed economy' using the UK economy as an example.

Exam tip

Bring a calculator with you to the exam. You might need it to work out various calculations such as ratios, economic trends and other calculations requested by the examiner.

A charity must be established for a public benefit and its aims and objectives must be considered by law to be charitable. The charity must have a purpose, such as the advancement of education, religion, health, citizenship, arts, culture, heritage, science, amateur sports, human rights, environmental protection or animal welfare. The purpose must be for the public benefit in order to be considered charitable. The Charity Commission decides whether an organisation passes the public benefit test.

A charity is run by trustees. Charities cannot make profits. All monies raised by the charity are specifically for the purpose of the charity. The receipts charities receive are called donations, which the general public makes after advertising campaigns. Examples of larger charities include the Bill & Melinda Gates Foundation, which is funded by Gates' own personal wealth generated through Microsoft and through Warren Buffett, who pledged most of his fortune to the Foundation. Other examples of charities are Marie Curie, Great Ormond Street Hospital, Oxfam and Water Aid.

The benefits of operating a charity include the following:

- Charities gain public recognition and trust. They are widely recognised as doing social good.
- All donations are used for charitable purposes.
- Charities are exempt from paying tax (i.e. tax relief).
- Gift Aid is available to charities, through which HMRC refunds 20% tax on all donations.
- In some circumstances, the charity does not pay VAT on some of its purchases (i.e. VAT relief).
- Charities can apply to major funders for grants.

The limitations to operating a charity include the following:

- Charities must submit their annual audited accounts and reports to the Charity Commission.
- Final accounts must be audited prior to submission to the Charity Commission, which increases costs.
- Charities must operate within certain restrictions.
- All trustees are considered voluntary and do not receive payment.
- A portion of the donations collected goes towards funding the administrative costs of running the charity, rather than the intended charitable purpose.
- Charities must comply with data protection laws and follow GDPR guidelines on data confidentiality, which increases costs.

Voluntary organisations

The voluntary sector is at the heart of civil society. Voluntary organisations, such as faith groups, youth clubs, sports clubs and housing associations, all fulfil a specific social purpose and engage in a wide range of issues, especially those not addressed by other organisations, such as drug abuse, affordable housing, climate change, domestic abuse support and representation. Many voluntary organisations offer direct support and advice to those people who ask for help or the most vulnerable in society. Voluntary organisations rely on donations and are not profit-orientated. All funds are appropriated to prioritised social objectives.

The boundaries between the public sector, the private sector and the voluntary sector are becoming increasingly blurred. The public sector outsources its services to the voluntary groups in the private sector. For example, the Education Authority (EA) funds the youth groups in the voluntary sector in order to safeguard the welfare of young people.

Many voluntary organisations are registered with the Charity Commission.

Business cycle

The **business cycle** affects all parts of the economy — growth, inflation, employment, interest rates, **exchange rates**, investment levels, business profits and balance of payments — depending on the stage it is in. There are four stages to the business cycle:

1 Boom

An **economic boom** occurs when the economy is peaking. The boom tends to be characterised by the following:

- There are high levels of consumer and business confidence.
- Consumer spending tends to be high due to high employment levels and positive economic growth.
- Unemployment levels tend to be low because businesses require their staff to keep up with the increasing demand for products.
- **Inflation** is on the increase due to increasing prices.
- High levels of investment tend to occur to facilitate expansion or replacement of key assets within a business.

2 Recession

An **economic recession** occurs when there is a general decline in economic activity, i.e. a decrease in the demand for goods. A recession tends to be characterised by the following:

- There is a pessimistic view of consumer and business confidence.
- Consumer spending decreases due to fear of layoffs.
- Economic growth starts to decline.
- Unemployment starts to increase.
- Inflation tends to decrease.
- Investment decreases.

3 Slump

A slump occurs when there is real fall in **gross domestic product (GDP)**. A slump tends to be characterised by the following:

- There are pessimistic levels of consumer and business confidence.
- Consumer spending decreases due to increasing layoffs. Demand decreases.
- Economic growth decreases to near 0%.
- Unemployment levels are high due to layoffs.
- The level of inflation tends to decrease because retail prices decrease.
- There are low levels of business investment and increased levels of saving.

Business cycle The pattern, or cycle, of economic events that tends to repeat itself over time in relation to changes in economic growth. It is a measure of changes either upward or downward in gross domestic product over the long term. Also known as a trade cycle.

Exchange rate Rate at which one currency is exchanged for another, e.g. £1 = US\$1.30.

Economic boom The expansion phase in the trade cycle, evidenced by a peak in spending and GDP.

Inflation An increase in the price of goods and services.

Economic recession The downswing phase in the trade cycle, evidenced by a reduction in spending and GDP.

Gross domestic product (GDP) The total monetary value of all goods and services produced in a nation in a year. GDP is a measure of the size and health of a country's economy over a period of time.

4 Recovery

Recovery occurs when there is real increase in GDP. Recovery tends to be characterised by the following:

- There is an increasing trend in consumer and business confidence.
- Consumer spending rises.
- Economic growth is on the increase.
- Unemployment levels decrease with new employment opportunities.
- Inflation rates tend to increase very slowly.
- The levels of business capital investment increase as cheap bank loans are made available.

Table 1 summarises the characteristics of each stage of the business cycle, and examines the effects of each stage on businesses.

Table 1 Characteristics of each stage of the business cycle and their effects on businesses

Stage	Characteristics	Effects on business
Boom	High demand for products Employment is high Unemployment levels are low Prices increase Consumer confidence is high Business profits increase Investment is high	Demand is high due to high employment levels. The increased income fuels the demand and demand overcomes supply. Therefore, prices increase in order to compensate for the increase in business profits.
Recession	Demand for products decreases Employment decreases Unemployment levels increase with business layoffs Prices decrease Consumer confidence decreases Business profits decrease No investment	Demand starts to decrease due to possible government intervention over inflation problems. Sales decrease accordingly and businesses lay off staff. Gloomy consumer confidence leads to businesses decreasing prices in order to increase demand. Business profits decrease and there are even losses.
Slump	Demand is low Few employment opportunities Unemployment levels are high Prices are low Consumer confidence is low Business profits are low No investment	The demand is low, with businesses running at sufficient staff. Unemployment levels go up leading to less money to spend on products. Luxury businesses close and business profits are very low.
Recovery	Demand begins to pick up gradually Employment levels gradually increase Unemployment levels decrease Stagnant prices increase Consumer confidence is on the increase Business profits increase Small but increasing investment	Government intervention is possible through investments. There is an increased demand for products, meaning employment levels increase. More income creates an increased demand for goods. Prices increase accordingly, leading to an increase in business profits.

Knowledge check 2

Explain the term 'gross domestic product (GDP)' with reference to the UK economy.

The importance of business confidence

We are taught that the markets are essentially rational, self-correcting, efficient and stable. There is little need for government interference as demand and supply will self-correct the markets and return them to equilibrium. Marginal firms leave the markets and new innovative businesses enter the markets to replace them. Decisions are made rationally.

But human psychology plays a major role in decision making in markets. Some decisions are based on reason and logic but many are based on irrational emotions. John Maynard Keynes states that decisions are made as a result of intuitive, emotional and irrational mind-sets. He coined the term 'animal spirits' to explain this idea. Animal spirits represent the emotions of confidence, optimism, hope, fear and pessimism, all of which affect the human decision-making process.

Confidence can drive economic growth while a lack of it can hamper economic growth. If the spirit belief is pessimistic, confidence will be low with regards to business investment, growth, loan applications and recruitment, even in a boom cycle. If the spirit animal is optimistic, confidence will be high with regards to business loan applications, investment, economic growth and recruitment, even in a recession cycle.

Governments must exercise control over animal spirits through their policy objectives, lest the animal spirit of greed forces business to chase maximised profits, which can lead to disastrous results, e.g. the 2008 financial crisis.

Business Confidence Index (BCI)

The **Business Confidence** Index (BCI) is the leading indicator of future developments in the UK economy. Business managers are surveyed and provide quantitative data on future sales revenue and future orders on their books, and qualitative data on their opinions regarding the economy. The index monitors the growth or decline in the manufacturing industry and predicts future trends in the economy. It determines how managers view the current situation and their future confidence in the economy, whether positive or negative.

If the index indicates a negative movement, i.e. the economy is stalling or heading into a recession, consumers refrain from spending their income on luxuries such as cars, holidays and home improvements, with accompanying staff layoffs in each of these markets.

The reduced confidence in the economy also affects banks and building societies, whose lending of business loans and mortgages decreases. This reduction in confidence goes on to affect the construction industry, which ceases building houses because banks and building societies won't lend monies for fear of customers' inability to repay their mortgages due to potential layoffs.

Summary

After studying this topic you should be able to:

- demonstrate and apply knowledge and understanding of the macroeconomic framework in which businesses operate
- analyse and evaluate the significance of a mixed economy, including social enterprise, and the charitable and voluntary sectors
- analyse and evaluate the impact of business cycles
- analyse and evaluate the importance of business confidence

Business confidence

An economic measure of how optimistic or pessimistic managers are about their business's prospects, which in turn impacts national economic performance.

Exam tip

The specification requires an analysis and evaluation of the importance of business confidence.

Knowledge check 3

Explain one reason why business confidence is important in an economy.

2 Read the following extract and answer the question that follows.

Extract 2 DairyLake Limited

DairyLake Limited is a family-owned dairy farm (with a small on-site creamery) located in County Antrim. Its products are all milk-based, including milk, butter, cheese, ice cream and yogurts, and all are sold to the large supermarket chains in the UK, under their own brand names. DairyLake Limited purchases all of its milk requirements from local farmers in Northern Ireland. Market research data indicated there was a growing demand for whey protein (a by-product of both cheese manufacturing and removal of fat and casein from milk), specifically in the sports nutrition drinks market. The data suggests that there are major opportunities in the coming years for expansion in to the sports nutrition drinks market, especially in the UK and European markets.

In 2018, the directors agreed with the dairy industry's outlook for NI dairy farmers' and dairies, who were expressing real concern for their future over issues such as pricing, possible tariffs and quotas. The directors agreed that to

survive and grow their business they must look to new profitable products such as whey, invest in new equipment to increase milk production, cut production costs and look at local dairy businesses to cater for their increased milk demand for whey. In late 2018, DairyLake Limited decided to invest £1 million with funding from both Invest NI and a bank mortgage. The investment breakdown was as follows:

- 1 Invested £100,000 in electrical generators and solar panels on its dairy farm. The generators will provide 25% of its energy needs and cut energy costs by 10%.
- 2 Invested £150,000 on new production facilities to increase the efficiency of milk production with cost-cutting advantages.
- 3 Invested £300,000 in new production facilities installed on the farm to cater specifically for the new range of whey-inspired dairy drink products solely directed at the expanding UK and European sports nutrition drinks market
- 4 £500,000 on a takeover of FinPat Dairies.

Table 1 Excerpts from DairyLake Limited's financial statements for the 3 years ended 31 December

	December 2019	Margin %	December 2018	Margin %	December 2017	Margin %
	£s		£s		£s	
Sales revenue	2,047,375		1,588,765		1,577,868	
Gross profit	388,654	18.98%	245,868	15.47%	251,367	15.93%
Net profit (after interest)	104,109	5.08%	40,988	2.58%	45,862	2.9%
Investments	1,000,000		0		0	
Bank loans	563,375		11,605		15,289	
Interest payable	32,581		600		750	

- a Evaluate DairyLake Limited's takeover of FinPat Dairies as a way of achieving growth. 20 marks

The 'evaluate' command word means you need to provide a thorough assessment of the evidence on both sides of the argument, i.e. benefits and drawbacks with evaluation. You should create an extract-based answer discussing the benefits and drawbacks of issues related to the business. You also need to give a final judgement about the issue in the context of the stimulus material and include other supporting business theories. You may use the extract to support application.

(A02) for demonstrating evidence of application of stimulus material to the business issues under discussion — in this case, DairyLake Limited's strategic takeover of FinPat Dairies as a way of achieving growth. Be sure to use application from the stimulus material in the correct manner. This is worth up to 4 marks.

(A03) for giving a good analysis of the benefits and drawbacks DairyLake Limited's strategic takeover of FinPat Dairies as a way of achieving growth. The analyses should be balanced, detailed, well reasoned and developed. This is worth up to 6 marks.

(A04) for giving an excellent and balanced evaluation of DairyLake Limited's strategic takeover of FinPat Dairies as a way of achieving growth. The benefits and drawbacks should be balanced and focused on the key issue. You should make your judgements with supporting comments and weight attached to the value of the points stated. This is worth up to 6 marks.

Student A answer

The use of takeover strategy to achieve growth is appropriate as it allows DairyLake to defend its market position and to gain opportunities in a new whey market **a**. One of DairyLake's key business objectives is to secure growth in the business through several methods but including takeovers. Taking over FinPat Dairies for £500,000 extends DairyLake's market share and because of this it will have access to FinPat milk sales on its way to becoming Northern Ireland's largest dairy business **b**. DairyLake will have access to FinPat's milk sales, which is additional sales to the whey nutrient drinks market without affecting its core products **c**. This takeover could have resulted in a sales revenue increase of £450,000 and increased profits of £63,000. The increased profits mean the company will have more funds to continue to develop its new whey product range, giving customers a larger product portfolio from which to choose. However, there is no guarantee that the takeover can help DairyLake increase growth and therefore it could be seen as a risky and costly investment, at £500,000 plus interest **d**. The case study also mentions the fear of decreasing milk prices, and milk quotas and tariffs, which will affect DairyLake's future sales revenue and profits.

The takeover of FinPat Dairies will reduce the costs of duplicated services **e**. Managers and staff will be laid off, reducing wages costs and increasing company profits. The cost for 2019 is £284,000 and all reductions will increase DairyLake's profits **f**. As the company had installed new production machinery in 2019, it may be able to reduce the use of older machinery in FinPat's dairy, again reducing production costs and increasing profits **g**. However, the cost of £500,000 for FinPat Dairies is bank financed and incurs interest charges of at least £16,000 per year (half of annual £32,000) over a long period of time. It could take many years for DairyLake to pay off this debt, although the profits have at least doubled due to the takeover **h**.

To conclude, DairyLake's takeover of FinPat Dairies was a positive one, and is responsible for some of the increase in profits during 2019 along with other cost-cutting strategies. The takeover may bring positive relief to the directors, as in 2018 they were facing major

Questions & Answers

issues that may have forced them to close down. However, there is no guarantee that milk prices will stay the same or that the new whey nutrients drinks market will continue to grow. ¶

(A01) **a e** The student has given an excellent response, with accurate knowledge, and a comprehensive, relevant and detailed explanation of DairyLake Limited's strategic takeover of FinPat Dairies as a way of achieving growth. The student's knowledge and understanding of the question and their answer was deemed excellent.

(A02) **b f** The student discusses, with the use of detailed relevant and financial data from both the financial excerpts and stimulus material, DairyLake Limited's strategic takeover of FinPat Dairies as a way of achieving growth. The student's constant and consistent use of information applied from the case study to reinforce their knowledge and understanding was deemed excellent.

(A03) **c g** The student provides a detailed analyses of DairyLake Limited's strategic takeover of FinPat Dairies as a way of achieving growth. The student provides a detailed analyses of how DairyLake Limited's takeovers are a way of achieving growth. The student's analysis of both objectives, with a logical chain of reasoning, was deemed excellent.

(A04) **d h i** The student gives a detailed evaluation of DairyLake Limited's strategic takeover of FinPat Dairies as a way of achieving growth, with a balanced judgement, a clear focus throughout, based on effective analysis and use of business language, and a highly appropriate, clear logical final judgement. The evaluation of both points with a final judgement was deemed excellent.

This is a Level 4 answer, with the student covering all assessment objectives via an excellent response, excellent application, excellent analysis and excellent evaluation. Middle mark is 18, but increased to 20 for an overall excellent answer, especially the analysis and evaluation. **20/20 marks awarded**

Student B answer

One advantage of a takeover is that DairyLake has instant access to new facilities **a**. As well as new facilities it will also gain more staff from FinPat Dairies, adding to its own employees **b**. The new employees may come with specialist skills and qualities that DairyLake can use to help grow the business on an even bigger scale. A disadvantage, however, is the increasing lack of communication DairyLake may face as it goes through with this takeover **c**. Since it gained a new business it will have to increase its chain of command in order to oversee all the new facilities and production processes. This increase in the chain of command means there will be less communication between the workers and people higher up, i.e. DairyLake Limited's managers. However, this lack of communication could lead to bad decision making, negatively affecting certain stakeholders and potentially stumping growth **d**.

Another advantage of DairyLake's takeover of FinPat Dairies is that economies of scale come along with it **e**. The financial economies of

scale will cut costs and increase profits, which should allow DairyLake to invest in new capital machinery **j**. The new technology will allow DairyLake to gain technological economies of scale while also expanding into new European regions, increasing brand growth **g**. However, DairyLake's takeover of FinPat and producing new whey nutrient drink products could cause a lack of motivation among staff. This could negatively affect the efficiency of production as well as product quality. This can therefore have an effect on the sales and profits of these products and lead to a decrease in growth **i**.

In conclusion, I believe that FinPat's takeover is a great way for DairyLake to achieve growth as it enables the company to gain instant benefits, since it is taking over already established companies, allowing for an easy boost in market share and growth. If DairyLake manages both companies correctly there shouldn't be a lack of communication or motivation problems across either business. I believe that with the immense economies of scale growth provides, a takeover is a great way of achieving growth. **j**

(A01) **a e** The student has given a good response, with sound, accurate knowledge and understanding, and explanation of DairyLake Limited's takeover of FinPat Dairies as a way of achieving growth, additional production facilities and economies of scale. The student's knowledge and understanding of the question and their answer was deemed good.

(A02) **b f** The student's discussion with the use of relevant data from the stimulus material was limited, as there was no use of financial data in the response to evaluate DairyLake Limited's takeover of FinPat Dairies as a way of achieving growth. This lack of information applied from the case study to reinforce knowledge and understanding was deemed satisfactory.

(A03) **c g** The student provides some analyses of DairyLake Limited's takeover of FinPat Dairies as a way of achieving growth. They provide a good analysis of how DairyLake Limited's takeover of FinPat Dairies is a way of achieving growth. The student analyses both additional production facilities and economies of scale with some chain of reasoning, which was deemed good.

(A04) **d h i** The student gives a good evaluation of DairyLake Limited's takeover of FinPat Dairies as a way of achieving growth, with a judgement, some focus throughout based on good analysis and use of business language, with a satisfactory final judgement. The student's evaluation of both points with a final judgement was deemed good.

This is a Level 3 answer, with the student covering all the assessment objectives via a good response, satisfactory application, good analysis and good evaluation. The middle mark is 13, with no reason to increase or decrease the mark. **13/20 marks awarded**