



PEARSON EDEXCEL  
INTERNATIONAL A LEVEL  
**ACCOUNTING**  
TEACHER RESOURCE PACK 2

- Check student responses to the activities and exam practice questions using the [student book answers](#).
- Prepare for exam success with [practice exam papers](#) and [mark scheme](#).
- Improve exam technique with [model exam answers](#) for each section of the exam paper, covering a range of command words. Also includes activities to embed knowledge of exam requirements.
- Support answer-writing technique for evaluate questions on the exam paper with a [framework](#) and [model answer commentary](#).

# IAL Accounting Exam Practice 'Recommend' style Question

## 2.6 Project appraisal

- Application of discounted methods
- Application of non-discounted methods

## Resource for question

Naifaru Construction has been offered a contract to build and operate a water treatment works in an area where there is a lot of water pollution. The following information is available:

- The cost of capital is 6%.
- Investment payback period required: less than five years.

The following calculations have been carried out for the investment:

- Net present value is (£87,350)
- Average rate of return: 5.2%
- Internal rate of return: 6.5%
- Payback is three years and 2 months.

## Exam question

Recommend whether Naifaru Construction should proceed with the project using both financial and non-financial factors. **(12)**

## Is this a good answer?

Case for the investment:

- The payback period is three years and two months, which is a short period of time as the water treatment works will last for a long time.
- They will get their money back quickly.

Case against the investment:

- The average rate of return (ARR) is not very high – only 6.5%.
- The net present value is negative by £87,350.

## Is this a good answer?

### Conclusion

I would recommend the project should proceed as the cost of capital is 6%, which is a good amount of return for a business to make.

## Examiner feedback

The marks available for this question are based on a standard levels of response for evaluation questions – Level 1 to Level 4. Each level contains all skills and so it is important that you recognise this when writing your answer. Writing in bullet points should be avoided at all times. It makes it difficult to apply and analyse the points made. This candidate has made some valid points (AO1) for and against but left it to the examiner to analyse these. The second bullet point in the case for the investment is a continuation of the first point rather than a new argument and therefore does not gain any credit. In the case against the investment, the candidate has misread the figure. The recommendation is an assertion rather than a reasoned judgement. This response would be awarded Level 1: 3 marks – limited knowledge, no application and generic assertion.

## Examiner review of assessment objectives

Case for the investment:

- The payback period is three years and two months, which is a short period of time as the water treatment works will last for a long time.
- They will get their money back quickly.

Case against the investment:

- The average rate of return (ARR) is not very high – only 6.5%.
- The net present value is negative by £87,350.

Key to assessment objectives: Knowledge and Understanding, Application, Analysis, Evaluation

## Examiner review of assessment objectives

### Conclusion

I would recommend the project should proceed as the cost of capital is 6%, which is a good amount of return for a business to make.

Key to assessment objectives: Knowledge and Understanding, Application, Analysis, Evaluation

## Activity

*Using the information from the previous slides, improve this answer to the question. Remember that this candidate only demonstrated limited knowledge of project appraisal methods and did not gain any marks for application. The candidate confused the IRR and ARR figures. Read the question carefully to understand both the figures given and the context. This will allow you to apply your answer. The candidate did not refer to any non-financial factors. While a recommendation was given, this was unsupported.*

## An example of best practice

One point in favour is that the payback period is only three years and two months. This is significantly shorter than the maximum payback period the company requires. As a result, they will get a return on the investment quickly, and less than the five-year length required. However, the payback period does not take into account cash in-flows after the payback period. It might be that the cash in-flows stop shortly after the payback period. If this were the case, it might mean the project should not go ahead.

From a non-financial viewpoint, the project should go ahead. Building the treatment works will solve the water pollution and so benefit the local community. Additionally, the construction will create employment opportunities both in the short term and long term, thus benefitting the local economy.

*Clear understanding shown, analysed and applied to the scenario. In addition, an element of evaluation is present in the argument.*

Key to assessment objectives: Knowledge and Understanding, Application, Analysis, Evaluation

## An example of best practice

However, it could be argued that the project should not go ahead as **the average rate of return of 5.2% is marginally below the required cost of capital benchmark of 6%**. As it is just below, it is not definite that the investment should be rejected, **however, as the NPV is negative, it further suggests the project should be rejected**. From a non-financial viewpoint, the treatment works may cause other pollution issues such as noise and increased traffic in the area, thus having a negative impact on the local community.

*Candidate has presented a counter argument, therefore providing a balanced answer that looks at both the case for and against accepting the contract.*

Key to assessment objectives: Knowledge and Understanding, Application, Analysis, Evaluation

## An example of best practice

In conclusion, from a financial aspect I would recommend that the project be rejected. As a plc, the primary objective is likely to be profit, and as the project has a negative NPV and a lower ARR than the cost of capital, the project does not meet the necessary criteria to go ahead. While the payback period is good, NPV is probably a better measure as it takes into account the time value of money and so backs up the decision not to proceed with the investment.

*A fully justified decision has been made. The candidate makes a decision and justifies it in the context of the arguments they have presented.*

Key to assessment objectives: Knowledge and Understanding, Application, Analysis, Evaluation

## Examiner feedback

Recommend questions require knowledge and understanding, application, analysis and evaluation. They are marked using levels of response. This response demonstrates accurate knowledge and understanding (AO1 – Level 4) and is supported by relevant and effective application applied to the context, using both financial and non-financial factors (AO2 – Level 4). There are logical chains of reasoning (AO4) and the assessment is balanced and in context throughout the response. The recommendation is informed and in context (AO4 – Level 4). The example would achieve Level 4 – full marks.

## Evaluate, essay guidance

Evaluate the usefulness of statements of cash flows in assessing the financial performance of limited companies.

(12)

### Score: Mid-Level 4 (11)

#### Colour key:

Knowledge

Application

Analysis

Evaluation/conclusion

A benefit of a statement of cash flow in assessing the financial performance of a limited companies is that it shows where the limited company has generated its cash and how it has utilised this cash. This helps the users of financial statements to assess if the company is generating sufficient cash to continue trading. A statement of cash flow shows the amount of cash that is generated from operating activities. This is a very important source of cash and in practice it would be difficult for a company to continue trading in both the long term and short term without cash from day-to-day trading activities.

However, a statement of cash flow only shows cash inflows and cash outflows. It does not show the profit of a limited company. In the short term a business may be able to carry on trading while making a loss as long as there are positive cash flows. However, in the long run a successful business must be able to generate a profit. Profit is a key indicator of financial performance. Cash inflows and cash outflows can be manipulated in the short term to create a positive cash flow.

A statement of cash flow can help assess the financial performance of a business as it shows how the business has used the cash during the year. The statement has different sections that reflect the different uses of the cash – from operating activities, investing activities and financing activities. This means potential investors can see if the company

#### Strengths

- A relevant point is made at the start.
- Developed chain of reasoning.

#### Weaknesses

- There is no need to write out the question again.
- The point made in the first paragraph should be expressed as two points – assessing the generation of cash is one use and assessing the utilisation of cash is another.

#### Weaknesses

- The argument that cash flows can be manipulated could have been applied by adding – non-current assets could be sold to increase the net cash from investing activities to improve the amount of cash in the business.

has invested in non-current assets. This could indicate good performance, despite the poor cash flow position, as the company could be about to expand and use the non-current assets to generate future profits.

A negative point about its usefulness is that the statement of cash flow does not show the liquidity of the company. The statement shows the absolute cash position of the business. It shows the opening and closing balances of cash and cash equivalents but it does not indicate the short-term liquidity position, the current ratio, the long-term liquidity or the gearing position. In order to assess the performance of a company these ratios need to be calculated. This will allow the user to assess the performance over time and between other similar companies.

In conclusion, a statement of cash flow is not a good indicator of the financial performance of a business as it does not show the profit or profitability of a company, which could be argued are the most important criteria in determining its success. While it shows how the cash has been generated and utilised, it does not show the liquidity of the company. It provides useful additional information, especially for non-experts, as it is based on actual cash movements and so is not subject to the application of accounting conventions and concepts.

#### Strengths

- Relevant points for and against relating to use as an indicator of financial performance.
- Arguments are good when developed with solid application.
- Supported and well-developed conclusion.

#### Weaknesses

- Application could be improved by greater reference to specific sections of the statement, but this does not detract from an excellent answer.

## Evaluate, essay framework

Evaluate the usefulness of statements of cash flows in assessing the financial performance of limited companies.

(12)

### Score: Mid-Level 4 (11)

#### Plan

Introduction	Not required.
1st point	Shows how cash is generated, especially from operations – importance of this.
1st point counter-balanced	Only shows cash, not profit/profitability. Profit as a key indication of financial performance.
2nd point	Shows how cash is utilised – purchase of non-current assets and inventory, predict future performance.
2nd point counter-balanced	Absolute vs relative cash position – does not show liquidity – current and gearing – which is needed to assess performance.
Conclusion and recommendation	Probably not a good indicator on its own – need profit and liquidity to assess financial performance.

#### Essay

1st point	A benefit of a statement of cash flow in assessing the financial performance of a limited companies is that it shows where the limited company has generated its cash and how it has utilised this cash. This helps the users of financial statements to assess if the company is generating sufficient cash to continue trading. A statement of cash flow shows the amount of cash that is generated from operating activities. This is a very important source of cash and in practice it would be difficult for a company to continue trading in both the long term and short term without cash from day-to-day trading activities.
1st point counter-balanced	However, a statement of cash flow only shows cash inflows and cash outflows. It does not show the profit of a limited company. In the short term a business may be able to carry on trading while making a loss as long as there are positive cash flows. However, in the long run a successful business must be able to generate a profit. Profit is a key indicator of financial performance. Cash inflows and cash outflows can be manipulated in the short term to create a positive cash flow.

2nd point	A statement of cash flow can help assess the financial performance of a business as it shows how the business has used the cash during the year. The statement has different sections that reflect the different uses of the cash – from operating activities, investing activities and financing activities. This means potential investors can see if the company has invested in non-current assets. This could indicate good performance, despite the poor cash flow position, as the company could be about to expand and use the non-current assets to generate future profits.
2nd point counter-balanced	A negative point about its usefulness is that the statement of cash flow does not show the liquidity of the company. The statement shows the absolute cash position of the business. It shows the opening and closing balances of cash and cash equivalents but it does not indicate the short-term liquidity position, the current ratio, the long-term liquidity or the gearing position. In order to assess the performance of a company these ratios need to be calculated. This will allow the user to assess the performance over time and between other similar companies.
Conclusion and recommendation	In conclusion, a statement of cash flow is not a good indicator of the financial performance of a business as it does not show the profit or profitability of a company, which could be argued are the most important criteria in determining its success. While it shows how the cash has been generated and utilised, it does not show the liquidity of the company. It provides useful additional information, especially for non-experts, as it is based on actual cash movements and so is not subject to the application of accounting conventions and concepts.