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Business Studies

Fourth Edition

Karen Borrington
Peter Stimpson



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Introduction and guidance for students

Who is this book for?

This book has been written for all students of Cambridge IGCSE® Business Studies. It carefully and precisely follows the newly revised syllabus from Cambridge International Examinations. It provides the detail and guidance that are needed by students to be successful in the examinations of this specification. It will also prove to be of great use to students of Edexcel International GCSE, Cambridge O level and GCSE Business Studies offered by other examining boards.

This book will prove to be valuable to students of Business Studies whether you are:

- studying the subject for the first time through your school or college and need a comprehensive and clearly written textbook
- revising the subject before your examinations and need a study guide to help you with key definitions, techniques and examination advice
- learning the subject on your own through distance or open learning and need a complete programme of supportive questions, activities and suggested answers to these.

Building on the successful formula of the three previous editions, this fourth edition updates all existing chapters including deleting material which will no longer be examined and adds new subject material with additional chapters and new features.

How this book can help you

To make your study of Business Studies as rewarding and successful as possible, this Cambridge endorsed textbook offers the following important features in each chapter:

- an outline of the subject material to be covered and a checklist at the end to confirm what you should have learned and understood
- chapter titles and chapter section headings that completely match those of the Cambridge IGCSE® Business Studies syllabus
- subject material written in an informative yet lively way that allows for complete understanding of each topic to be gained
- numerous activities to support your learning and check your progress at each important stage of every chapter
- revision summaries in the form of helpful 'spider diagrams' that highlight key topics and issues
- definitions of all important terms that might be examined
- case studies based on a range of international businesses
- examination-style questions at the end of each chapter to allow you to gain essential practice at answering questions to Cambridge IGCSE® standard
- further case study examination-style questions at the end of each group of chapters covering a specific section of the curriculum content

- ‘Tips for success’ tips to help you make key points when answering questions
- and finally, hundreds of activities for you to do! These are focused on specific sections of the syllabus and will help you to develop your knowledge and application skills.

What is on the CD?

This is an innovation for the fourth edition. It contains:

- outline answers to the activities in each chapter
- sample answers to one of the examination-style questions from each chapter
- over 300 interactive multiple-choice questions, split into the chapters contained in the textbook, to allow further testing of your learning
- a revision questions worksheet for each chapter – with outline answers
- a glossary of all key terms that have been defined in the textbook.

The information and details contained on the CD are so useful that your teacher may take this out of your copy of the book – so that he or she can use the questions, worksheets and answers with you as they go through the course.

Is there a Teacher’s CD too?

Yes! This is available separately (ISBN: 9781444176520) and provides for teachers:

- answers to all the remaining questions not given in the textbook CD
- a scheme of work
- teaching activities and worksheets
- sample examination questions with sample answers.

The Teacher’s CD has not been through the Cambridge endorsement process.

Exam preparation and technique

Revision

You should be able to perform to the best of your ability if you:

- ensure that you have worked through all of the activities and examination-style questions in this book
- revise thoroughly before the examination – allow plenty of time for this and avoid leaving it until the last minute.

You can also help yourself greatly if you take the following steps.

- Obtain a copy of the syllabus. You should also be able to obtain past examination papers and mark schemes. It is very important that you check the progress of your learning and revision by ‘ticking off’ each topic against the syllabus content.
- Make sure that you know the number and length of each of the examination papers you will have to sit. The style and nature of the questions often differ between papers so you must be quite clear about the type of questions likely to appear on each paper.

For Cambridge IGCSE® Business Studies the examination papers are:

| | Length | Type of paper | Type of questions |
|---------|----------------|---------------|--|
| Paper 1 | 1 hour 30 mins | Data response | Four data response questions based on four different businesses. The questions are structured a) to e) |
| Paper 2 | 1 hour 30 mins | Case study | Four structured questions (i.e. a and b)) all based on a case study |

In the examination

Make sure you check the instructions on the question paper, the length of the paper and the number of questions you have to answer. In the case of Cambridge IGCSE® Business Studies examinations you will have to answer every question as there will be no choice.

Allocate your time sensibly between each question. Every year, good students let themselves down by spending too long on some questions and too little time (or no time at all) on others. You will be expected to spend longer writing an answer to a question worth 12 marks than you would when writing an answer worth eight marks.

Remember that the most common 'prompt' words are 'identify', 'define' and 'consider'. The following guide should help you.

Key examination prompt words you need to know

What is meant by

This is asking you to clearly show the examiner that you know what a term means. A single sentence answer is nearly always sufficient.

Identify

As in 'Identify **two** factors that could influence the price of a product.' Identify means write down, without explanation or discussion, the required number of points.

So the answers to the question above might be:

- 1 Costs of production.
- 2 Prices of competitors' products.

Calculate

As in 'Using the figures provided, calculate the break-even level of production.' This means 'using the figures provided, work out the following'.

Explain

As in 'Explain **two** ways in which the hotel could promote its services'.

Here the examiner is asking you to give more detail than just identifying points. Your answer must also be *applied to the business in question – in this case, a hotel*. So, advertising on TV would not be appropriate for one hotel given the high cost of TV time. A better answer would be:

- 1 The hotel could contact all guests who have stayed at the hotel before by email to give them details of a special offer.
- 2 The hotel could also use a colourful and effective website to promote its services to customers who book hotel accommodation online.

Consider

As in 'Consider whether the car manufacturer should reduce prices to increase demand.' This is asking you to show advanced skills. The best approach to answer this type of question is to explain the advantages and disadvantages of reducing car prices – using any case material about the business to help you. You should then

weigh up these advantages and disadvantages *applied to a car manufacturer* and compare them before making a final conclusion.

Recommend

As in 'Recommend which method of production the soft drinks manufacturer should use.' This is similar to 'consider'. A recommendation *without* explaining the advantages and disadvantages of different production methods will earn you no marks. It is very important to base your recommendation on the explanations you have given in the first part of your answer and to *apply all of the points made to the soft drinks manufacturer*. Your recommendation should also explain why the other methods are less suitable.

Do you think that ...

As in 'Do you think that Sasha was right to choose the city centre location for her new shoe shop? Justify your answer.'

You will notice the last three words of this question 'Justify your answer'. You will earn no marks if your only answer to this question is: 'Yes she was right.!'.

In cases like this, you need to explain the advantages and disadvantages of locating a *shoe shop* in each of the locations given to you in the case. Finally, you should weigh up the points for and against and come to a final decision, 'Yes' or 'No', based on your most important points.

Why have we *italicised* key sentences in the explanations above? This is because these sentences are about the skill of application – linking your answer to the business in the data or case study. This is the easiest way to maximise your chances in an examination once you have shown relevant knowledge. 'Application' is a very important skill for Business Studies students. Use all of the activities in this book and the examination-style questions to help you become an expert in applying answers to particular businesses.

Finally ...

Learning Business Studies should be both rewarding and challenging. We hope that this textbook and CD-ROM will help you overcome the challenges of the Cambridge IGCSE® course so that you can achieve the success you are seeking. In particular, we want the book to encourage you to develop a real interest in – even a passion for – finding out more of how the world of business really works. Business activity is so crucial to the future wellbeing of us all and it offers great opportunities for all well-motivated students. Success in Cambridge IGCSE® Business Studies can help you take the first important steps towards playing a leading role in managing and directing business activity in your country. We are confident that this book will fully support you during your course.

Karen Borrington
Peter Stimpson

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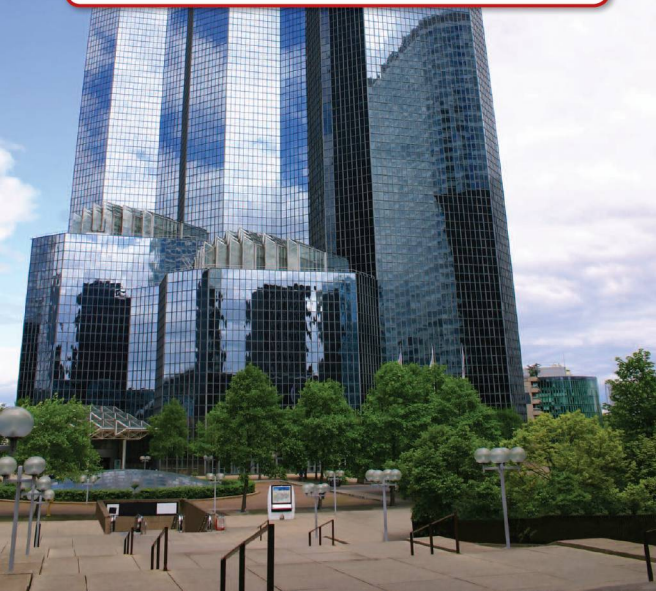
Section

1

Understanding business activity

Chapters

- 1 Business activity
- 2 Classification of businesses
- 3 Enterprise, business growth and size
- 4 Types of business organisation
- 5 Business objectives and stakeholder objectives



This chapter will explain:

- the concept of needs, wants, scarcity and opportunity cost
- the factors of production
- the development of economic activity and the use of specialisation
- the purpose of business activity
- the concept of added value.

The economic problem: needs, wants and scarcity

Definitions to learn

A **need** is a good or service essential for living.

A **want** is a good or service which people would like to have, but which is not essential for living. People's wants are unlimited.

The **economic problem** – there exist unlimited wants but limited resources to produce the goods and services to satisfy those wants. This creates scarcity.

Activity 1.1

Make lists of:

- a) your needs – those things you think are necessary for living
- b) your wants – things you would like to be able to buy and own.

For example, on your needs list you will probably include clean water, and on your wants list you may include a luxury house.

What do you notice about your two lists? Probably the really important items are on the **needs** list – water, clothing for warmth and protection, food and some form of housing or shelter. And on your **wants** list? That will be up to you and your interests and tastes, but you could probably have written a very long list indeed.

Do you already own all of the items on your wants list? If you do, then you must be very lucky and very rich! Most people in the world cannot afford to buy everything they want because our wants are unlimited. In many countries, some people cannot afford to buy the things they need and they are likely to be very poor.

Why are there so many wants and needs that we cannot satisfy? Why are millions of people living in poverty in many countries around the world? Most people will answer these questions by saying, 'Because there is not enough money'.

Is the real **economic problem** caused by a shortage of money? An example may help to show you why more money is not the answer to the problem of many people's wants and needs not being satisfied.

Case study example

The Government of a small country is worried about large numbers of people who cannot afford the basic needs of life. Even those citizens with more money are always complaining that the country is not producing enough of the luxuries that they want to buy. The Government decides to try to 'solve' these problems by printing more bank notes doubling everyone's incomes.

Has the Government solved the economic problem of the country? Are there now more goods for the people to buy? More houses? More schools? More cars? Improved standard of living of the population?

The answer to all of these questions is 'No'. Printing more money does not produce more goods and services. It will just lead to prices rising so more goods cannot be afforded – you just pay more for the same amount of goods.

The economic problem – the real cause

The real cause of the shortage or scarcity of goods and services is that there are not enough **factors of production** to make all of the goods and services that the population needs and wants.

There are four factors of production:

- **Land** – this term is used to cover all of the natural resources provided by nature and includes fields and forests, oil, gas, metals and other mineral resources.
- **Labour** – this is the number of people available to make products.
- **Capital** – this is the finance, machinery and equipment needed for the manufacture of goods.
- **Enterprise** – this is the skill and risk-taking ability of the person who brings the other resources or factors of production together to produce a good or service. For example, the owner of a business. These people are called entrepreneurs.

In any one country, and in the world as a whole, these factors of production are limited in supply. As there is never enough land, labour, capital or enterprise to produce all of the needs and unlimited wants of a whole population, there is an economic problem of **scarcity**.

Definitions to learn

Factors of production are those resources needed to produce goods or services. There are four factors of production and they are in limited supply.

Scarcity is the lack of sufficient products to fulfil the total wants of the population.



The real cause of the economic problem

Limited resources: the need to choose

We make choices every day. We have to, as we have limited resources but so many wants. We therefore have to decide which wants we will satisfy and those which we will not. All choices involve giving something up – this leads to **opportunity cost**. Should I take a bus to school or use the money for a new pen to write clear Business Studies notes? Do I buy a new pair of trainers or spend the money on a new mobile phone?

We do not have the resources to satisfy all our wants so the next best alternative that we give up becomes our opportunity cost. This problem of ‘what to give up’ exists not only for consumers like us but for governments and businesses too. In making choices we need to consider carefully the opportunity cost to make sure it is not worth more to us than the item we are buying.

Definitions to learn

Opportunity cost is the next best alternative given up by choosing another item.

Tips for success

There are many definitions of key terms in this book – they are in the left hand margin.

It is very important that you learn these by heart for use in your examination answers!



Holiday or car?



The individual chooses to buy the holiday, so the car becomes the opportunity cost



Machine A or Machine B?



The company decides to buy Machine A, so Machine B becomes the opportunity cost



New road or new school?

The government chooses to build the road so the school becomes the opportunity cost

Examples of opportunity cost

Revision summary: the economic problem



Specialisation: the best use of limited resources

Definitions to learn

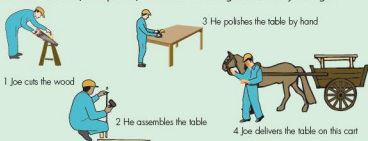
Specialisation occurs when people and businesses concentrate on what they are best at.

In all societies the factors of production are in limited supply. It is therefore important to use these resources in the most efficient ways possible. The ways in which these resources are used have changed greatly in the last 200 years. Very few products are now made just by the efforts and skills of one worker. Nearly all workers specialise in one skill and most businesses specialise on one product. **Specialisation** is now very common because:

- specialised machinery and technology are now widely available
- increasing competition means that businesses have to keep costs low
- most people recognise that higher living standards can result from being specialised.

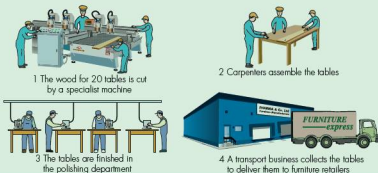
Case study example

This is how Joe Sharma, a carpenter, went about making a table 200 years ago:



What do you notice about these methods of production?

- Joe did everything himself – including the cutting of the timber and the sale and delivery of the finished table.
- Production was very low – only one table per week.
- Compare this with typical modern production methods. Two hundred years later, Jack Sharma owns the family business. This is how production is organised:

**Definitions to learn**

Division of labour is when the production process is split up into different tasks and each worker performs one of these tasks. It is a form of specialisation.

Specialisation and the division of labour

Jack Sharma is using the principles of specialisation and **division of labour**. He is dividing up the making of tables into different jobs and making each worker a specialist at just one task. Division of labour has advantages and disadvantages:

| Advantages | Disadvantages |
|---|--|
| <ul style="list-style-type: none"> ● Workers are trained in one task and specialise in this – this increases efficiency and output ● Less time is wasted moving from one workbench to another | <ul style="list-style-type: none"> ● Workers can become bored doing just one job – efficiency might fall ● If one worker is absent and no one else can do the job, production might be stopped |

Activity 1.2

- Using another product, for example bread or clay pots, explain, with simple illustrations, how division of labour or specialisation could be used to make the product.
- Explain the possible advantages/disadvantages of using division of labour (or specialisation of labour) to the business you chose.

The purpose of business activity

We have identified the following issues.

- People have **unlimited** wants.
- The four factors of production – the resources needed to make goods – are in **limited supply**.
- Scarcity results from limited resources and unlimited wants.
- Choice is necessary when resources are scarce. This leads to **opportunity cost**.
- **Specialisation** improves the efficient use of resources.

So far, we have hardly mentioned **businesses** and yet this is the purpose of this book!

Where does business activity fit into the ideas we have already looked at?

The purpose of all businesses is to combine the factors of production to make products which will satisfy people's wants. These products can either be goods – physical items such as cars and shoes which we can touch and see – or they can be services, such as insurance, tourism or banking.

Businesses can be small – just one person, for example – or large. Some businesses employ thousands of people with operations in many different countries. Businesses can be privately owned or owned by the state. They can be owned by one person or by thousands of shareholders.

Whatever their size and whoever owns them, all businesses have one thing in common – they combine factors of production to make products which satisfy people's wants.

Definitions to learn

Businesses combine factors of production to make products (goods and services) which satisfy people's wants.



Farms

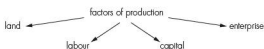


Offices



Factories

Businesses in all sectors of industry produce goods and services by combining factors of production



What would life be like without business activity? In simple, undeveloped societies, businesses do not exist. Everyone attempts to do everything for themselves – they are self-sufficient. With their own plot of land and by their own efforts, such as hunting, they attempt to survive and produce enough for their own needs. This is a very basic existence and living standards are low.

By a slow process of specialisation, people began to concentrate on what they were best at. They then traded those goods for others made by people who have different skills. In this way, businesses began to be formed, and trade and exchange of goods expanded. In today's world, most people specialise by working in one job for a weekly wage. With this money, they are able to purchase a wide range of goods and services produced by many different businesses – specialising in different products.

Business activity therefore:

- combines scarce factors of production to produce goods and services
- produces goods and services which are needed to satisfy the needs and wants of the population
- employs people as workers and pays them wages to allow them to consume products made by other people.

Added value

This is a very important idea. All businesses attempt to **add value**. If value is not added to the materials and components that a business buys in then:

- other costs cannot be paid for
- no profit will be made.

Definitions to learn

Added value is the difference between the selling price of a product and the cost of bought in materials and components.

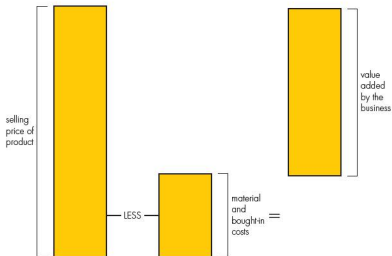


Diagram showing value added

Tips for success

Adding value is not easy for many businesses – if it was, every business would be very successful! When some businesses try to increase added value it can lead to serious disadvantages. For example, just increasing the price of the product can lead to lower sales and, perhaps, lower profit.

Tips for success

You should take every chance to apply your answers to the business in the question. A jewellery shop is likely to add value in different ways to a hotel business or a soft drinks manufacturer.

Example:

- The selling price of a newly built house is \$100 000.
- The value of the bought in bricks, cement, wood and other materials was \$15 000.
- The added value of the building firm was \$85 000. This is not profit – out of this the builder must pay wages and other costs too.

Why is added value important?

Added value is important because sales revenue is greater than the cost of materials bought in by the business. This means the business:

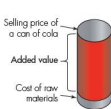
- can pay other costs such as labour costs, management expenses and costs such as advertising and power
- may be able to make a profit if these other costs total less than the added value.

How could a business increase added value?

There are two main ways in which a business can try to increase its added value.

- Increase selling price but keep the cost of materials the same. This might be possible if the business tries to create a higher quality image for its product or service. If consumers are convinced by this then they might be prepared to pay higher prices and buy the same quantity as before the price rise. A jewellery shop could employ very experienced and knowledgeable sales staff, decorate the shop in a very up-market way and use high quality packaging. Note though: other costs might increase when trying to create this quality image.
- Reduce the cost of materials but keep the price the same. A building firm could use cheaper wood, bricks and other materials when constructing a home or shop. If the price charged to customers stays the same then a higher added value will be made. Note though: lower priced materials might reduce the quality of the product. Will customers be prepared to pay the same price for a product that they believe is of lower quality?

Revision summary: adding value



Case study example – Rakesh's bakery

Rakesh owns a small bakery selling bread, cakes and biscuits. His business is just making enough money to survive. His wife, Neeta, had the idea of serving customers tea and coffee at two small tables that could be fitted into the bakery shop. 'Customers will pay more for each cake and biscuit if we sell them with tea or coffee – just like a little café.' Rakesh bought some second-hand café equipment and furniture and tried what Neeta had suggested. She was right! Some of his customers not only bought teas and coffees but they paid higher prices for the cakes and biscuits they bought as they were served them on a plate!

Rakesh had increased the value added to the flour, sugar and butter he used to make these cakes and biscuits.

Activity 1.3

Refer to the Rakesh's bakery case study.

- If the best-selling cake in this bakery uses 30 cents worth of flour, sugar and butter and Rakesh sells each one for \$1, calculate the value added.
- If customers are prepared to pay \$1.50 when this cake is served on a plate at a table within the bakery, what is the new value added per cake?
- Does the opening of the small café mean that Rakesh must have increased his weekly profit? Explain your answer.

International business in focus: division of labour at McDonald's

The cooking of food in all McDonald's restaurants is broken down into small, repetitive tasks. These include serving staff, pouring drinks, cooking French fries and cooking burgers. These separate tasks allow workers to become very efficient and skilled in them. All workers are given much training in the tasks that they will become skilled at.

The speed and efficiency of McDonald's workers means that customers are served very quickly with freshly cooked food. Costs are kept very low and this helps to keep prices low.

McDonald's and other fast food restaurants often make great efforts to reduce high labour turnover in this industry.

Discussion points

- Why do you think a large business such as McDonald's uses specialisation?
- Think about as many advantages as you can to McDonald's of using specialisation.
- If you owned a fast food restaurant, consider **two** ways in which you could increase the value added to the food bought in by the restaurant.



Exam-style questions – Paper 1

- 1 Gowri plans to start up her own business using her own savings. She wants to produce fashion clothes for women. She is a very good clothes designer but she does not like stitching clothes together. Two friends have offered to help Gowri. Abha is an experienced material cutter – she can cut lengths of material for clothes with very little wastage. Aditi is quick at sewing.
- a) What is meant by 'business'? [2]
 - b) Identify **two** factors of production that Gowri will need for her new business. [2]
 - c) Identify and explain **two** possible opportunity costs that Gowri may have from her decision to start her own business. [4]
 - d) Identify and explain **one** advantage and **one** disadvantage to Gowri's business of using division of labour in making clothes. [6]
 - e) Do you think that Gowri's business will be able to sell all of the clothes that it makes? Justify your answer. [6]
- 2 Mohammed owns a bakery. He makes bread and cakes. He employs three workers who help him mix the dough for the bread and cakes, put the dough into tins, bake the bread and cakes and serve customers. Mohammed has calculated that the 'added value' of his business is low. His customers complain when he tries to put up prices. 'We can buy the same bread and cakes at lower prices' they tell him.
- a) What is meant by 'added value'? [2]
 - b) Mohammed has just bought a new oven. Explain 'opportunity cost' to Mohammed. [2]
 - c) Identify and explain **two** benefits to Mohammed's business of all of his workers being able to do all of the jobs in the bakery. [4]
 - d) Identify and explain **two** ways in which Mohammed could increase the value added of his bakery business. [6]
 - e) A friend told Mohammed 'Your business would be more successful if you only served in the shop and let your workers make the bread and cakes'. Do you agree? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- what the 'economic problem' means
- the difference between wants and needs
- why scarcity of resources results in choices and opportunity cost
- why specialisation is important
- the purpose and nature of business activity
- how businesses can try to increase added value.

NOW – test your understanding with the revision questions on the CD-ROM.

2

Classification of businesses

This chapter will explain:

- the differences between primary, secondary and tertiary production
- why the importance of these business activities varies between countries and over time
- the differences between public sector and private sector businesses in mixed economies.

Stages of economic activity

As you read this book you are probably sitting at a desk. Most desks are still made of wood. How many different types of businesses might have been involved in converting the wood into a finished desk ready to be sold to a final consumer? What stages of production has the wood passed through to arrive at the finished desk?

The diagram below shows the most likely stages in the production and sale of a wooden desk.



The stages involved in making and selling a wooden desk

Definitions to learn

The **primary sector** of industry extracts and uses the natural resources of the earth to produce raw materials used by other businesses.

You will notice that there are three main stages from the cutting down of the timber to the sale of the completed desk. These stages are typical of nearly all production and they are called the levels of economic – or business – activity.

Stage 1 is called the primary stage of production. This stage involves the earth's natural resources. Activities in the **primary sector** of industry include farming, fishing, forestry and the extraction of natural materials, such as oil and copper ore.

Stage 2 is called the secondary stage of production. This stage involves taking the materials and resources provided by the primary sector and converting them into

Definitions to learn

The **secondary sector** of industry manufactures goods using the raw materials provided by the primary sector.

manufactured or processed goods. Activities in the **secondary sector** of industry include building and construction, aircraft and car manufacturing, computer assembly, bread baking.

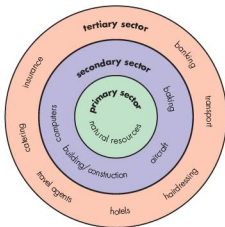


Definitions to learn

The **tertiary sector** of industry provides services to consumers and the other sectors of industry.

Examples of activities in the different sectors of industry: rice farming in Vietnam, clothes production in China and retailing in Kenya

Stage 3 is called the tertiary stage of production. This stage involves providing services to both consumers and other businesses. Activities in the **tertiary sector** of industry include transport, banking, retail, insurance, hotels and hairdressing.



The three types of business activity

Activity 2.1

Copy this table. Indicate with a tick which sector of industry each business is in.

| Business | Primary | Secondary | Tertiary |
|-------------------|---------|-----------|----------|
| Insurance | | | |
| Forestry | | | |
| Coal mining | | | |
| Computer assembly | | | |
| Travel agent | | | |
| Bakery | | | |
| Car showroom | | | |

Relative importance of economic sectors

Which sector of industry is most important in your country? This depends on what is meant by 'important'. Usually the three sectors of the economy are compared by:

- percentage of the country's total number of workers employed in each sector
or
- value of output of goods and services and the proportion this is of total national output.

In some countries, primary industries such as farming and mining employ many more people than manufacturing or service industries. These tend to be countries – often called developing countries – where manufacturing industry has only recently been established. As most people still live in the rural areas with low incomes, there is little demand for services such as transport, hotels and insurance. The levels of both employment and output in the primary sector in these countries are likely to be higher than in the other two sectors.

In countries which started up manufacturing industries many years ago, the secondary and tertiary sectors are likely to employ many more workers than the primary sector. The level of output in the primary sector is often small compared to the other two sectors. In economically developed countries, it is now common to find that many manufactured goods are bought in from other nations. Most of the workers will be employed in the service sector. The output of the tertiary sector is often higher than the other two sectors combined. Such countries are often called the most developed countries.

Case study – Comparing the three economic sectors: India and Botswana

The relative importance of the three economic sectors in India is very different to that in Botswana. India does not have large reserves of primary products (natural resources) but Botswana has some of the largest diamond mines in the world. Extracting this valuable resource makes a huge contribution to the Botswana economy.

India's textile, steel and car manufacturing industries are rapidly growing but the secondary sector in Botswana is small – meat processing and textiles are the most important secondary industries. If Botswana developed a jewellery industry making rings and other jewellery from the diamonds extracted from its mines, secondary production would increase. The tertiary sector is expanding in both countries – tourism is very important in Botswana and providing IT services to businesses all over the world is India's largest service industry.

| % of total national output 2011 | Primary | Secondary | Tertiary |
|---------------------------------|---------|-----------|----------|
| Botswana | 35 | 13 | 52 |
| India | 14 | 29 | 57 |

Activity 2.2

Refer to the case study above.

- Explain what tertiary production means by using examples from the case.
- Identify and explain two reasons why the primary sector is relatively more important to Botswana than India.
- In 2011, it was estimated that 45 per cent of Indians worked in the primary sector – mainly agriculture. Why was this sector the least important of the three in terms of output?
- Discuss the likely impact on Botswana if its diamond mines become exhausted (the diamonds run out!).

Definitions to learn

De-industrialisation occurs when there is a decline in the importance of the secondary, manufacturing sector of industry in a country.

Changes in sector importance

In the UK and other developed economies there has been a decline in the importance of manufacturing industry – or the secondary sector – since the 1970s. The tertiary sector in the UK now employs well over 70 per cent of all workers. Many workers who have lost jobs as factories closed have found it difficult to obtain work in the service industries. The decline in the manufacturing or secondary sector of industry is called **de-industrialisation**.

In China and India, the relative importance of the secondary sector has increased since the 1980s, compared to the primary sector. However, in both countries, many of the tertiary sector industries are now expanding more rapidly than those in both the primary and secondary sectors. There are several reasons for changes in the relative importance of the three sectors over time.

- Sources of some primary products, such as timber, oil and gas, become depleted. This has been true for Somalia with the cutting down of most of its forests.
- Most developed economies are losing competitiveness in manufacturing to the newly industrialised countries such as Brazil, India and China.
- As a country's total wealth increases and living standards rise, consumers tend to spend a higher proportion of their incomes on services such as travel and restaurants than on manufactured products produced from primary products.

Tips for success

The examination questions will not test your knowledge of actual countries' economies, but a question might refer to 'low-income' or 'high-income' countries. Different patterns of economic/business activity often exist between these types of economies.

Case study – Bangladesh: the importance of economic sectors over time

In 1970, Bangladesh (formerly East Pakistan) had an economy largely based on agriculture. A high proportion of the population worked in farming either to produce crops for self-sufficiency or to sell in local markets. Secondary manufacturing activities were relatively unimportant and the tertiary sector was also small as incomes were very low and people had little spare cash to spend on 'services'.

By 2011, Bangladesh had undergone significant changes. Although 40 per cent of the workforce still works in agriculture, primary production of goods such as jute, tobacco and food has fallen in relative terms. Manufacturing industries – notably food processing and clothing – have expanded rapidly. Tertiary services such as telecommunications, transport and finance now contribute approximately half of total national output.

Economic sectors in Bangladesh – World Bank estimates of % share of GDP

| | Primary | Secondary | Tertiary |
|------|---------|-----------|----------|
| 1970 | 53 | 15 | 32 |
| 2011 | 23 | 26 | 51 |

Activity 2.3

Refer to the case study above.

- Identify and explain two possible reasons why the relative importance of primary output has fallen.
- Would workers who formerly worked in agriculture find it easy to obtain jobs in the secondary or tertiary sectors of industry? Explain your answer.
- What do you expect to happen to the relative importance of tertiary industries if incomes continue to rise in Bangladesh? Explain your answer.

Definitions to learn

A **mixed economy** has both a private sector and a public (state) sector.

Mixed economy

Nearly every country in the world has a **mixed economy** with a:

- private sector – businesses not owned by the government. These businesses will make their own decisions about what to produce, how it should be produced and what price should be charged for it. Most businesses in the private sector will aim to run profitably. Even so, there are likely to be some government controls over these decisions and these are explained in other chapters in this book.
- public sector – government- or state-owned and controlled businesses and organisations. The government, or other public authority, makes decisions about what to produce and how much to charge consumers. Some goods and services are provided free of charge to the consumer, such as state health and education services. The money for these comes not from the user but from the taxpayer. Objectives of private-sector and public-sector businesses are often different (see Chapter 4).

Which business activities are usually in the public sector?

In many countries the government controls the following important industries or activities:

- health
- education
- defence
- public transport
- water supply
- electricity supply.

Activity 2.4

For each of the examples of key industries or activities listed above, suggest three possible reasons why the government of a country might decide to own and control that industry or service.

Activity 2.5

Find out whether, in your own country, the government owns and controls the following businesses:

- a) railway system
- b) local bus services
- c) water supply
- d) electricity supply
- e) TV and radio stations
- f) hospitals.

Mixed economies – recent changes

In recent years, many governments have changed the balance between the private sector and the public sector in their economies. They have done this by selling some public sector businesses – owned and controlled by government – to private sector businesses. This is called privatisation. In many European and Asian countries the water supply, electricity supply and public transport systems have been privatised.

Why have governments done this? It is often claimed that private sector businesses are more efficient than public sector businesses. This might be because their main objective is profit and therefore costs must be controlled. Also private sector owners might invest more capital in the business than the government can afford. Competition between private sector businesses can help to improve product quality.

However, a business in the private sector might make more workers unemployed than a public sector business in order to cut costs. A private sector business is also less likely to focus on social objectives.

Definitions to learn

Capital is the money invested into a business by the owners.

Tips for success

There will be no questions in your Cambridge IGCSE® examination on privatisation but the advantages and disadvantages of the private sector are useful to remember.

Tips for success

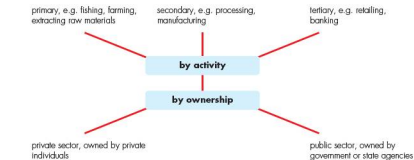
Do not confuse 'privatisation' with 'converting a sole trader into a private limited company'. Sole traders and private limited companies are both examples of private-sector businesses (see Chapter 4).

Changes in the balance between the private sector and the public sector are likely to continue in many mixed economies.

Activity 2.6

Your Government is considering the privatisation of your country's postal services. You decide to write to the Government minister in charge, explaining your views on this matter and stating your opinion. Your letter should contain:

- an explanation of the difference between private sector businesses and public sector businesses
- the possible benefits of the postal service being in the private sector
- the possible disadvantages to the postal service being in the private sector
- your recommendation to the minister on whether to keep the postal service in the public sector or not.

Revision summary: sectors of industry

International business in focus: tourism in Mauritius

Mauritius is a small island in the Indian Ocean with a land area of just 2000 km². The Mauritian economy is dominated by the tertiary sector. In 2011, tourism, finance and other services accounted for 66 per cent of total national output (gross domestic product). In contrast, the secondary sector accounted for 28 per cent and primary industries – mainly sugar production – just 6 per cent. The Government is planning for 2 million foreign visitors by 2015 and the number of tourists is increasing by 9 per cent per year. These tourists spend a great deal of money on food, drink, travel and holiday gifts.

Air Mauritius is one of the businesses that have benefited greatly from the expansion of tourism in the country. The airline is partly owned by private owners and the Mauritian Government. It has won the 'Indian Ocean Leading Airline' prize six times in recent years.

Air Mauritius not only has an extensive network of air routes but it also offers services to other airlines operating in the region and owns holiday companies such as Mauritian Holidays UK. There are hundreds of hotels and guesthouses in Mauritius and these employ many local workers. Some of the largest hotel groups in the world operate in Mauritius, such as Radisson and Le Meridien.



Discussion points

- Why do you think the primary sector of the Mauritian economy is relatively small?
- Explain three ways in which tertiary sector industries contribute to the Mauritian economy.
- Do you think that increasing numbers of tourists will bring only benefits to Mauritius?
- Why do you think the Mauritian Government still owns a part of Air Mauritius?

Exam-style questions – Paper 1

- 1 Ade's Engineering Company (AEC) makes parts for cars and trucks. These are sold to car manufacturers in many countries. The parts include metal brake components and rubber seals to fit around windows. AEC operates in Country X, which, until a few years ago, had an economy dominated by agriculture and coal mining. Over the last 20 years the relative importance of the primary sector has declined. To be successful AEC requires natural resources to make car parts and the services provided by other businesses. Consumer incomes are rising rapidly in Country X.
- What is meant by 'primary sector'? [2]
 - Identify **two** examples of services that a business such as AEC requires. [2]
 - Identify and explain **two** reasons why a business such as AEC could not be successful without other firms providing natural resources. [4]
 - Identify and explain **two** likely reasons why the relative importance of the primary sector of Country X's economy has declined. [6]
 - A Government minister in Country X recently said: 'The secondary sector of industry will always be more important than the tertiary sector to our economy.' Do you agree with this view? Justify your answer. [6]
- 2 The Government of Country Y owns and controls many businesses. 'The public sector always produces goods and services more efficiently than privately owned businesses', a Government minister recently said. Other ministers disagree and want to privatise many state-owned businesses. The private sector businesses in Country Y produce 55 per cent of total output – mainly in services such as transport, tourism and finance. The secondary sector of industry produces 35 per cent of total output.
- What is meant by 'public sector'? [2]
 - Identify **two** industries in the secondary sector. [2]
 - Identify and explain **two** reasons why the tertiary sector of industry is becoming more important in most economies. [4]
 - Identify and explain **two** possible reasons why some ministers want to privatise some businesses in the public sector. [6]
 - Do you agree with the Government minister's view that: 'The public sector always produces goods and services more efficiently than privately owned businesses'? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- the differences between the three sectors of economic/business activity
- reasons why these sectors vary in importance between countries
- reasons why these sectors vary in importance over time
- the differences between the private sector and public sector in mixed economies
- arguments for and against privatisation.

NOW – test your understanding with the revision questions on the CD-ROM.

3

Enterprise, business growth and size

This chapter will explain:

- the importance of enterprise to new businesses
- the key characteristics of successful entrepreneurs
- the importance of a business plan to an entrepreneur
- how to measure and compare the size of businesses
- how business can expand internally and by merger and takeover
- why some businesses remain small and why some businesses fail.

Definitions to learn

Entrepreneur is a person who organises, operates and takes the risk for a new business venture.

Enterprise and entrepreneurship

What will you do when you leave school or college? Maybe go to university or get a job. Some of you may decide to take the risk of setting up your own business – this could be full- or part-time. If you do decide to do this then you will become an **entrepreneur!**

What are the benefits – and possible disadvantages – to starting up your own business?

| Benefits of being an entrepreneur | Disadvantages of being an entrepreneur |
|--|---|
| <ul style="list-style-type: none"> ● independence – able to choose how to use time and money ● able to put own ideas into practice ● may become famous and successful if the business grows ● may be profitable and the income might be higher than working as an employee for another business ● able to make use of personal interests and skills | <ul style="list-style-type: none"> ● risk – many new entrepreneurs' businesses fail, especially if there is poor planning ● capital – entrepreneurs will have to put their own money into the business and, possibly, find other sources of capital ● lack of knowledge and experience in starting and operating a business ● opportunity cost – lost income from not being an employee of another business |

For many successful entrepreneurs, starting up their own business has led to great wealth and fame. How many of these business leaders have you heard of? They all started out as entrepreneurs with their own business idea.

| Entrepreneur | Nationality | Main business interests |
|------------------|--------------|---|
| Richard Branson | UK | Virgin group of companies including airline, mobile phones and train services |
| Dhirubhai Ambani | India | Reliance group of companies including chemicals, IT and retailing |
| Pan Shiyi | China | Property |
| Herman Mashaba | South Africa | Cosmetics |
| Mark Zuckerberg | US | Social networking site Facebook |
| Steve Wozniak | US | Apple computers |



Mark Zuckerberg



Sir Richard Branson



Steve Wozniak

Tips for success

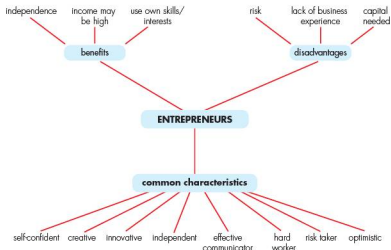
Think about why these successful entrepreneurs are important to the country they are based in. You should be able to explain why governments want to encourage more entrepreneurs to set up in business.

Characteristics of successful entrepreneurs

Would everyone make a good entrepreneur? Probably not – some people do not like risk or working independently – they might prefer to be an employee of a large business instead.

| Characteristics of successful entrepreneurs | Reasons why important |
|---|--|
| Hard working | Long hours and short holidays are typical for many entrepreneurs to make their business successful. |
| Risk taker | Making decisions to produce goods or services that people might buy is potentially risky. |
| Creative | A new business needs new ideas – about products, services, ways of attracting customers – to make it different from other existing firms. |
| Optimistic | Looking forward to a better future is essential – if you think only of failure you will fail! |
| Self-confident | Being self-confident is necessary to convince other people of your skills and to convince banks, other lenders and customers that your business is going to be successful. |
| Innovative | Being able to put new ideas into practice in interesting and different ways is also important. |
| Independent | Entrepreneurs will often have to work on their own before they can afford to employ others. Entrepreneurs must be well motivated and be able to work without any help. |
| Effective communicator | Talking clearly and confidently to banks, other lenders, customers and government agencies about the new business will raise the profile of the new business. |

Revision summary: entrepreneurs



Why governments support business start-ups

Most governments offer support to entrepreneurs. This encourages them to set up new businesses. There are several reasons why this support is given.

- Reduce unemployment – new businesses will often create jobs to help reduce unemployment.
- Increase competition – new businesses give consumers more choice and compete with already established businesses.
- Increase output – the economy benefits from increased output of goods and services.
- Benefit society – entrepreneurs may create social enterprises which offer benefits to society other than jobs and profit (for example, supporting disadvantaged groups in society).
- Can grow further – all large businesses were small once! By supporting today's new firms the government may be helping some firms that grow to become very large and important in the future.

What support do governments often give to start-up businesses?

| Business start-ups need: | Governments often give support by: |
|--------------------------|--|
| Business idea and help | Organising advice and support sessions offered by experienced business people |
| Premises | 'Enterprise zones', which provide low-cost premises to start-up businesses |
| Finance | Loans for small businesses at low interest rates Grants, if businesses start up in depressed areas of high unemployment |
| Labour | Grants to small businesses to train employees and help increase their productivity |
| Research | Encouraging universities to make their research facilities available to new business entrepreneurs |

How a business plan assists entrepreneurs

A bank will almost certainly ask an entrepreneur for a **business plan** before agreeing to a loan or overdraft to help finance the new business.

By completing a business plan (most banks are able to give business owners a ready-printed form to fill out) the entrepreneur is forced to think ahead and plan carefully for the first few years. The entrepreneur will have to consider:

- What products or services do I intend to provide and which consumers am I 'aiming at'?
- What will be my main costs and will enough products be sold to pay for them?
- Where will the firm be located?
- What machinery and how many people will be required in the business?

Without this detailed plan the bank will be reluctant to lend money to the business. This is because the owners of the new business cannot show that they have thought seriously about the future and planned to meet the challenges that they will certainly meet. Even with a detailed business plan, the bank might not offer a loan if the bank manager believes that the plan is not well completed (for example, poorly forecasted cash flow).

An example of a business plan is shown on the next page. It was completed by two entrepreneurs planning to open a takeaway pizza restaurant.

Definitions to learn

A **business plan** is a document containing the business objectives and important details about the operations, finance and owners of the new business.

Revision summary: business plans



Tips for success

You need to know what the main parts of a business plan are and be able to explain why a particular business might benefit from developing such a plan.

Case study example – Business plan for Pizza Place Ltd

| | |
|---|---|
| Name of business | Pizza Place Ltd |
| Type of organisation | Private limited company |
| Business aim | To provide a high-class takeaway pizza service including home delivery |
| Product | High-quality home-cooked pizzas |
| Price | Average price of \$5 with \$1 delivery charge |
| Market aimed for | Young people and families |
| Market research undertaken and the results | Research in the area conducted using questionnaires Also, research into national trends in takeaway sales and local competitors Results of all research in the appendix to this plan |
| Human Resources plan | Two staff (the business owners) to be the only staff to be employed initially |
| Details of business owners | Peter Yang – chef of 15 years' experience Sabrina Hsui – deputy manager of a restaurant for three years |
| Production details and business costs | Main suppliers – P & P Wholesalers Fixed costs of business – \$50000 per year Variable costs – approximately \$1 per unit sold |
| Location of business | Site in shopping street (Brunei Avenue) just away from the town centre Leasehold site (10 years) |
| Main equipment required | Second-hand kitchen equipment – \$4000 Second-hand motorbike – \$1000 |
| Forecast profit | See financial appendix to this plan Summary: In the first year of operations the total costs are forecast to be \$55000 with revenue of \$85000. Predicted profit = \$30000 Level of output to break-even – 12500 units per year |
| Cash flow | See financial appendix to this plan Due to the high set-up and promotion costs there will be negative cash flow in the first year |
| Finance | \$10000 invested by each of the owners Request to bank for a further \$10000 plus an overdraft arrangement of \$5000 per month |

Activity 3.1

Read the business plan for Pizza Place Ltd above. Explain why, if you were a bank manager reading this plan, each of the following would be important to you before you gave the entrepreneurs a loan:

- market research results
- experience of business owners
- forecast profit.

Activity 3.2

Draw up another business plan. It should be based on your own idea for a business that is operated within your own school or college (for example, a stationery shop, confectionery store or cake shop).

Activity 3.3

Research into the background and business activities of two well-known entrepreneurs in your own country. Identify the personal characteristics that you believe each entrepreneur has which have helped them to succeed. Write a brief report on each one and be prepared to present your reports to the rest of your class.

Comparing the size of businesses

Businesses can vary greatly in terms of size. On the one hand, firms can be owned and run by a single individual. At the other extreme, some businesses employ hundreds of thousands of workers all over the world. Some firms produce output worth hundreds of dollars a year, whilst the biggest businesses sell goods valued at billions of dollars each year.

Who would find it useful to compare the size of businesses?

- Investors – before deciding which business to put their savings into.
- Governments – often there are different tax rates for small and large businesses.
- Competitors – to compare their size and importance with other firms.
- Workers – to have some idea of how many people they might be working with.
- Banks – to see how important a loan to the business is compared to its overall size.

Business size can be measured in a number of ways. The most common are:

- number of employees
- value of output
- value of sales
- value of **capital employed**.

They all have advantages and limitations.

Number of employees

This method is easy to calculate and compare with other businesses.

Limitations: Some firms use production methods which employ very few people but which produce high output levels. This is true for automated factories which use the latest computer-controlled equipment. These firms are called capital-intensive firms – they use a great deal of capital (high cost) equipment to produce their output. Therefore, a company with high output levels could employ fewer people than a business which produced less output. Another problem is: should two part-time workers who work half of a working week each, be counted as one employee – or two?

Definitions to learn

Capital employed is the total value of capital used in the business.

Value of output

Calculating the value of output is a common way of comparing business size in the same industry – especially in manufacturing industries.

Limitations: A high level of output does not mean that a business is large when using the other methods of measurement. A firm employing few people might produce several very expensive computers each year. This might give higher output figures than a firm selling cheaper products but employing more workers. The value of output in any time period might not be the same as the value of sales if some goods are not sold.

Value of sales

This is often used when comparing the size of retailing businesses – especially retailers selling similar products (for example, food supermarkets).

Limitations: It could be misleading to use this measure when comparing the size of businesses that sell very different products (for example, a market stall selling sweets and a retailer of luxury handbags or perfumes).

Value of capital employed

This means the total value of capital invested into the business.

Limitations: This has a similar problem to that of the ‘number of employees’ measure. A company employing many workers may use labour-intensive methods of production. These give low output levels and use little capital equipment.

There is no perfect way of comparing the size of businesses. It is quite common to use more than one method and to compare the results obtained.



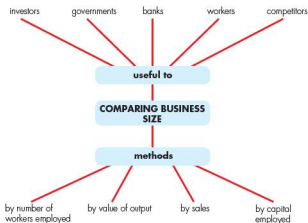
A capital-intensive business and a labour-intensive business

Activity 3.4: Comparing business size

You are employed by Company A, which makes motorcycles. You have been asked to write a brief report to the Managing Director comparing the size of your company with three others in the same industry. Use the following information in your report. State the advantages and disadvantages of each of the ways of comparing business size.

| | Workers employed | Capital employed (\$m) | Value of output (\$m) |
|-----------|------------------|------------------------|-----------------------|
| Company A | 20000 | 50 | 100 |
| Company B | 5000 | 150 | 300 |
| Company C | 3000 | 60 | 160 |
| Company D | 15000 | 180 | 150 |

Revision summary: comparing business size



Why do owners often want their businesses to grow?

The owners of businesses often want their firm to expand. What advantages will a business and its owners gain from expansion? Here are some likely benefits:

- the possibility of higher profits for the owners
- more status and prestige for the owners and managers – higher salaries are often paid to managers who control the bigger firms
- lower average costs (explained in Chapter 18, page 225, *Economies of scale*)
- larger share of its market – the proportion of total market sales it makes is greater. This gives a business more influence when dealing with suppliers and distributors and consumers are often attracted to the ‘big names’ in an industry.

Definitions to learn

Internal growth occurs when a business expands its existing operations. **External growth** is when a business takes over or merges with another business. It is often called **integration** as one firm is integrated into another one. A **merger** is when the owners of two businesses agree to join their firms together to make one business. A **takeover** or **acquisition** is when one business buys out the owners of another business which then becomes part of the 'predator' business (the firm which has taken it over).

Horizontal integration is when one firm merges with or takes over another one in the same industry at the same stage of production.

Vertical integration is when one firm merges with or takes over another one in the same industry but at a different stage of production. Vertical integration can be forward or backward.

Conglomerate integration is when one firm merges with or takes over a firm in a completely different industry. This is also known as **diversification**.

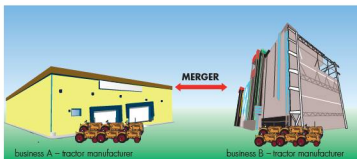
How can businesses grow?

Businesses can expand in two main ways:

- by **internal growth**, for example, a restaurant owner could open other restaurants in other towns – this growth is often paid for by profits from the existing business. This type of growth is often quite slow but easier to manage than external growth
- by **external growth**, involving a **takeover** or a **merger** with another business.

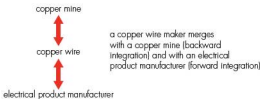
Three examples of external growth are shown below.

- **Horizontal merger** (or **horizontal integration**) – when one firm merges with or takes over another one in the same industry at the same stage of production.



An example of horizontal integration

- **Vertical merger** (or **vertical integration**) – when one firm merges with or takes over another one in the same industry but at a different stage of production. Vertical integration can be forward – when a firm integrates with another firm which is at a later stage of production (i.e. closer to the consumer), or **backward** – when a firm integrates with another firm at an earlier stage of production (closer to the raw material supplies, in the case of a manufacturing firm).



Backward and forward integration

- **Conglomerate merger** (or **conglomerate integration**) – when one firm merges with or takes over a firm in a completely different industry. This is also known as **diversification**.



A business building houses merges with a business making clothes

You should notice that all three examples of integration are very different even though they all involve two businesses joining together.

The likely benefits of integration

Horizontal integration

- The merger reduces the number of competitors in the industry.
- There are opportunities for economies of scale (see Chapter 18).
- The combined business will have a bigger share of the total market than either firm before the integration.

Forward vertical integration

For example, a car manufacturer takes over a car retailing business.

- The merger gives an assured outlet for their product.
- The profit margin made by the retailer is absorbed by the expanded business.
- The retailer could be prevented from selling competing makes of car.
- Information about consumer needs and preferences can now be obtained directly by the manufacturer.

Backward vertical integration

For example, a car manufacturer takes over a firm supplying car body panels.

- The merger gives an assured supply of important components.
- The profit margin of the supplier is absorbed by the expanded business.
- The supplier could be prevented from supplying other manufacturers.
- Costs of components and supplies for the manufacturer could be controlled.

Conglomerate integration

- The business now has activities in more than one industry. This means that the business has diversified its activities and this will spread the risks taken by the business. For example, suppose that a newspaper business took over a social networking company. If sales of newspapers fell due to changing consumer demand, sales from advertising on social network sites could be rising at the same time due to increased interest in this form of communication.
- There might be a transfer of ideas between the different sections of the business even though they operate in different industries. For example, an insurance firm buying an advertising agency could benefit from better promotion of its insurance activities as a result of the agency's new ideas.

Activity 3.5

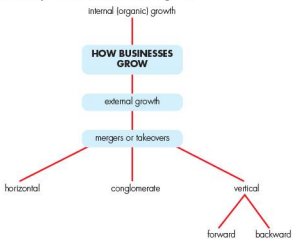
Identify the form of business growth which is used in each of these situations.

- A garage agrees to merge with another garage.
- A bicycle retailer expands by buying a bicycle shop in another town.
- A fruit juice firm buys a fruit farm.
- A business making electrical goods agrees to join with a business with retail shops specialising in electrical goods.
- A mining firm takes over a firm supplying mining equipment.
- A construction company buys a holiday company.

Activity 3.6

In each of the cases in Activity 3.5, identify and explain two likely reasons for the expansion.

Revision summary: how businesses grow



Case study – Nestlé takeover of large Chinese sweet maker

Nestlé is the largest food and confectionery manufacturer in the world. The company made the decision to takeover Hsu Fu Chi International (based in Guangdong, China). This Chinese company makes sweets and snacks. The takeover cost US\$1.7billion. It will now be easier for Nestlé to sell its products in China. There should also be cost savings from the takeover. Some consumers are worried that there might be less choice of sweets and snacks than before the takeover. Also, perhaps Nestlé might increase prices now that there will be less competition in the sweet and snack market.

Activity 3.7

Read the case study on the previous page.

- Is this takeover an example of 'horizontal' or 'vertical' integration? Explain your answer.
- Identify and explain two possible reasons why Nestlé took over the Hsu Fu Chi company.
- Do you think consumers in China will benefit from this takeover? Explain your answer.



A Nestlé Factory in China

Problems of business growth – and how to overcome them

Not all business expansion leads to success. There are several reasons why business expansion can fail to increase profit or achieve the other objectives set by managers.

| Problem resulting from expansion | Possible ways to overcome problem |
|--|--|
| Larger business is difficult to control (see also Diseconomies of scale, Chapter 18) | Operate the business in small units – this is a form of decentralisation |
| Larger business leads to poor communication (see Chapter 9) | Operate the business in smaller units Use latest IT equipment and telecommunications – but even these can cause problems |
| Expansion costs so much that business is short of finance | Expand more slowly – use profits from slowly expanding business to pay for further growth Ensure sufficient long-term finance is available (see Chapter 21) |
| Integrating with another business is more difficult than expected (e.g. different management styles or 'ways of doing things') | Introducing a different style of management requires good communication with the workforce – they will need to understand the reasons for the change |

Why do some businesses stay small?

Not all businesses grow. Some stay small, employing few people and using relatively little capital. There are several reasons why many businesses remain small:

- the type of industry the business operates in
- the market size
- the owners' objectives.

The type of industry the business operates in

Here are some examples of industries where most firms remain small: hairdressing, car repairs, window cleaning, convenience stores, plumbers, catering. Firms in these industries offer personal services or specialised products. If they were to grow too large, they would find it difficult to offer the close and personal service demanded by consumers. In these industries, it is often very easy for new firms to be set up and this creates new competition. This helps to keep existing firms relatively small.

Market size

If the market – that is, the total number of customers – is small, the businesses are likely to remain small. This is true for firms, such as shops, which operate in rural areas far away from cities. It is also why firms which produce goods or services of a specialised kind, which appeal only to a limited number of consumers, such as very luxurious cars or expensive fashion clothing, remain small.

Owners' objectives

Some business owners prefer to keep their firm small. They could be more interested in keeping control of a small business, knowing all of their staff and customers, than running a much larger business. Owners sometimes wish to avoid the stress and worry of running a large firm.

Why some businesses fail

Not all businesses are successful. The rate of failure of newly formed businesses is high – in some countries, over 50 per cent close within five years of being set up. Even old-established businesses can close down because they make losses or run out of cash. The main reasons why some businesses fail are:

- **Poor management** – this is a common cause of new business failures. Lack of experience can lead to bad decisions, such as locating the business in an area with high costs but low demand. Family businesses can fail because the sons and daughters of the founders of a business do not necessarily make good managers – and they might be reluctant to recruit professional managers.
- **Failure to plan for change** – the business environment is constantly changing – this features in many of the later chapters. This adds to the risk and uncertainty of operating a business. New technology, powerful new competitors and major economic changes are just some of the factors that can lead to business failures *if* they are not responded to effectively.

- **Poor financial management** – shortage of cash (lack of liquidity) means that workers, suppliers, landlords and government cannot be paid what they are owed. Failure to plan or forecast cash flows can lead to this problem and is a major cause of businesses of all sizes failing.
- **Over-expansion** – as was seen above (page 31), when a business expands *too* quickly it can lead to big problems of management and finance. If these are not solved, the difficulties can lead to the whole business closing down.
- **Risks of new business start-ups** – many new businesses fail due to lack of financial and other resources and research. In addition, the owner of a new business may lack the experience and decision making skills of managers who work for larger businesses. This means that new businesses are nearly always more at risk of failing than existing, well-established businesses.

International business in focus: Tata grows through takeovers

The Tata group is one of the largest companies in Asia measured by value of output. It is a conglomerate as it operates in many industries including: electricity, steel, cars, chemicals, hotels and – tea!

Much of Tata's growth has resulted from takeovers of other businesses. For example, it bought out Daewoo's truck division in South Korea and Jaguar Land Rover in the UK. Tata car making uses many products, such as steel and plastics, produced by other Tata factories.

Each division of the vast Tata empire is given much independence in how it is managed – this means more decisions are not taken centrally at Head Office.

The success of Tata's car division is in great contrast to SAAB, the Swedish car maker. This business failed in 2012 and stopped making cars. Its new models were too expensive and did not meet car customers' changing needs – and the business simply ran out of cash.

Discussion points

- What are some of the benefits to Tata of being a 'conglomerate'?
- Why do you think Tata's managers have used takeovers as a method of growth?
- If the Tata Car division was to takeover a chain of garages selling cars, what form of integration would this be? Do you think this would be a good idea?



Tata's cars

Exam-style questions – Paper 1

- 1 Sabrina was bored with her job in a clothing factory. Her main passion was fashion and she had always been good at selling since helping her father on his market stall. She encouraged her parents and some friends to invest in her idea for opening a shop selling good quality ladies clothes. Sabrina, as the entrepreneur behind the idea, was prepared to risk her own savings too. She had some exciting ideas for the shop layout and presentation of clothes.
- a) What is meant by 'entrepreneur'? [2]
 - b) Identify **two** benefits to Sabrina of starting her own business. [2]
 - c) Identify and explain **two** characteristics that Sabrina seems to have that might lead to success of her business. [4]
 - d) Identify and explain **two** benefits to Sabrina of keeping her business small. [6]
 - e) 'I think I should draw up a business plan before I start', said Sabrina to a friend. 'I think it would be best if you set the business up now – you don't need a plan as the shop will be so small', said her friend. Which view do you agree with? Justify your answer. [6]
- 2 TelCom owns a phone network and provides phone network services to many consumers. The business does not manufacture phones and it does not own retail stores selling them. Senior managers at TelCom are considering a takeover of either a phone manufacturer or a chain of phone shops. TelCom employs 4000 workers and, last year, recorded total sales of \$300 million. In contrast, the largest manufacturer of mobile phones, PhonTec, has 450 workers and recorded total sales last year of \$1200 million.
- a) What is meant by 'takeover'? [2]
 - b) Identify **two** other ways a business might grow apart from takeovers. [2]
 - c) Identify and explain **two** reasons why external groups would be interested in measuring the size of businesses such as TelCom. [4]
 - d) Identify and explain **two** possible reasons why senior managers at TelCom want to expand the business. [6]
 - e) How should TelCom expand – taking over a phone manufacturer or a chain of shops selling mobile phones? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- what an entrepreneur is and what characteristics successful entrepreneurs have
- the needs of a new business
- the importance of a business plan
- how size of businesses is measured
- the different ways in which a business can grow
- possible problems resulting from business growth
- reasons why some businesses remain small and why some businesses fail.

NOW – test your understanding with the revision questions on the CD-ROM.

4

Types of business organisation

This chapter will explain:

- the main forms of business organisation in the private and public sectors
- the advantages and disadvantages of each of these forms of business organisation
- how appropriate each of these forms are in different circumstances
- business organisations in the public sector.

Business organisations: the private sector

There are five main forms of business organisation in the private sector. These are:

- sole traders
- partnerships
- private limited companies
- public limited companies
- co-operatives.

Sole traders

Sole trader is the most common form of business organisation. It is a business owned and operated by just one person – the owner is the sole proprietor. One of the reasons it is such a common form of organisation is because there are so few legal requirements to set it up. The only legal regulations which must be followed are:

- the owner must register with, and send annual accounts to, the Government Tax Office
- the name of the business is significant. In some countries the name must be registered with the Registrar of Business Names. In other countries, such as the UK, it is sufficient for the owner to put the business name on all of the firm's documents and to put a notice in the main office stating who owns the business
- in some industries, the sole trader must observe laws which apply to all firms in that industry. These include health and safety laws and obtaining a licence, for example, to sell alcohol or operate a taxi.

What are the benefits and disadvantages to sole traders of running their own business rather than having other people join in with them? If you wanted to set up your own business, why might you choose to create a sole trader organisation? We can answer these questions by looking at the following case study.

Definitions to learn

Sole trader is a business owned by one person.

Case study example

Mike decided to start his own taxi business. He set up the business as a sole trader. These are the advantages to Mike of being a sole trader.

Advantages of being a sole trader

- There are few legal regulations for him to worry about when he set up the business.
- He is his own boss. He has complete control over his business and there is no need to consult with or ask others before making decisions.
- He has the freedom to choose his own holidays, hours of work, prices to be charged and whom to employ (if he finds that he could not do all the work by himself).

Definitions to learn

Limited liability means that the liability of shareholders in a company is only limited to the amount they invested.

Unlimited liability means that the owners of a business can be held responsible for the debts of the business they own. Their liability is not limited to the investment they made in the business.

- Mike has close contact with his own customers, the personal satisfaction of knowing his regular customers and the ability to respond quickly to their needs and demands.
- Mike has an incentive to work hard as he is able to keep all of the profits, after he pays tax. He does not have to share these profits.
- He does not have to give information about his business to anyone else – other than the Tax Office. He enjoys complete secrecy in business matters.



After operating the business for several months, Mike realised that there are also some disadvantages to being a sole trader. He made a list of them.

Disadvantages of being a sole trader

- I have no one to discuss business matters with as I am the sole owner.
- I do not have the benefit of **limited liability**. The business is not a separate legal unit. I am therefore fully responsible for any debts that the business may have. **Unlimited liability** means that if my business cannot pay its debts, then the people I owe money to (my creditors) can force me to sell all of my own possessions in order to pay them.
- I want to expand the business by buying other taxis – but I do not have enough money to do this. The sources of finance for a sole trader are limited to the owner's savings, profits made by the business and small bank loans. There are no other owners who can put capital into the business. Banks are often reluctant to lend large amounts to businesses like mine.
- My business is likely to remain small because capital for expansion is so restricted. My business is unlikely to benefit from economies of scale. I cannot offer much training or opportunities for my workers' future careers.
- If I am ill there is no one who will take control of the business for me. I cannot pass on the business to my sons – when I die the business will legally not exist any longer. This is because there is no continuity of the business after the death of the owner.

These disadvantages are typical for all sole traders. Did Mike take the correct decision to set up a sole trader business? He still thought so. He would recommend a sole trader structure to people who:

- are setting up a new business
- do not need much capital to get the business going
- will be dealing mainly with the public, for example in retailing or providing services like hairdressing – personal and direct contact between the customer and the owner is often very important for the success of these businesses.

But, as his business began to expand, Mike wondered if another form of business organisation would now be more suitable.

Tips for success

A sole trader can employ other people – but there is only one person that owns the business.

Definitions to learn

Partnership is a form of business in which two or more people agree to jointly own a business. A **partnership agreement** is the written and legal agreement between business partners. It is not essential for partners to have such an agreement but it is always recommended.

Definitions to learn

An **unincorporated business** is one that does not have a separate legal identity. Sole traders and partnerships are unincorporated businesses.

Partnerships

A **partnership** is a group or association of at least two people who agree to own and run a business together. In some countries, such as India, there is a maximum limit of 20 people. The partners will contribute to the capital of the business, will usually have a say in the running of the business and will share any profits made.

Partnerships can be set up very easily. Mike could just ask someone he knew to become his partner in the taxi business. This would be called a verbal agreement. Mike would be advised to create a written agreement with a partner called a **partnership agreement** or deed of partnership. Without this document, partners may disagree on who put most capital into the business or who is entitled to more of the profits. A written agreement will settle all of these matters.

Case study example

Mike offered his friend, Gita, the chance to become a partner in his taxi business. They prepared a written partnership agreement which contained the following points:

- the amount of capital invested in the business by both partners
- the tasks to be undertaken by each partner
- the way in which the profits would be shared out
- how long the partnership would last
- arrangements for absence, retirement and how new partners could be admitted.

The two partners signed the agreement. After the partnership had been operating for some time, it became clear to Mike that it had several advantages over a sole trader.

Advantages of a partnership

- More capital could now be invested into the business from Gita's savings and this would allow expansion of the business. Additional taxis could now be purchased.
- The responsibilities of running the business were now shared. Gita specialised in the accounts and administration of the business. Mike concentrated on marketing the services of the taxi firm and on driving. Absences and holidays did not lead to major problems as one of the partners was always available.
- Both partners were motivated to work hard because they would both benefit from the profits. In addition, any losses made by the business would now be shared by the partners.

Although the taxi business expanded and profits were being made, Gita became worried about what would happen if the business failed, perhaps because so many new competitors were entering the market. Gita explained to Mike that although their partnership was working well, this form of business organisation still had a number of disadvantages.

Disadvantages of a partnership

- The partners did not have limited liability. If the business failed, then creditors could still force the partners to sell their own property to pay business debts.
- The business did not have a separate legal identity. If one of the partners died, then the partnership would end. (Both sole traders and partnerships are said to be **unincorporated businesses** because they do not have a separate legal identity from the owners.)
- Partners can disagree on business decisions and consulting all partners takes time.
- If one of the partners is very inefficient or actually dishonest, then the other partners could suffer by losing money in the business.
- Most countries limit the number of partners to 20 and this means that business growth would be limited by the amount of capital that 20 people could invest.

Mike and Gita discussed these points with their solicitor. They agreed that partnerships were very suitable in certain situations:

- when people wished to form a business with others but wanted to avoid legal complications
- where the professional body, such as medicine and the law, only allowed professional people to form a partnership, not a company
- where the partners are well known to each other, possibly in the same family, and want a simple means of involving several of them in the running of the business.

Gita and Mike made it clear that they wanted to expand the business further but wanted to reduce personal risk. They wanted to protect their own possessions from business creditors in the event of failure.



As partners, Mike and Gita often discuss important business issues together. They share their ideas on how to run the business

The solicitor advised them to consider forming a private limited company. She explained that this type of business organisation would be very different from a partnership and would have its own benefits and drawbacks.

Activity 4.1

Your friend, Amin, is an expert computer engineer. He currently works for a large computer manufacturer. He thinks that he could run his own successful business. He has no experience of running a business. He has very few savings to invest into a business.

Amin has a rich uncle who knows nothing about computers! He is a retired businessman. He is friendly but rather bossy as he always thinks he knows best.

Amin asks for your advice about whether he should set up his own business and what form of organisation he should choose. He asks for your help on three questions that are worrying him.

- Identify and explain two advantages and two disadvantages to Amin of running his own business rather than working for the computer manufacturer.
- Do you think he should set up a sole trader business? Explain your answer.
- His uncle would like to become his partner in the business if Amin decides to go ahead. Identify and explain two advantages and two disadvantages to Amin of forming a partnership with his uncle.

Limited partnerships

In some countries it is possible to create a Limited Liability Partnership. The abbreviation for this new form of legal structure is LLP. It offers partners limited liability but shares in such businesses cannot be bought and sold. This type of partnership is a separate legal unit which still exists after a partner's death, unlike ordinary partnerships that end with the death of one of the partners.

Revision summary: sole traders and partnerships



Private limited companies

There is one essential difference between a company and an unincorporated business, such as a sole trader or partnership. A company is a separate legal unit from its owners – they are **incorporated businesses**. This means that:

- a company exists separately from the owners and will continue to exist if one of the owners should die
- a company can make contracts or legal agreements
- company accounts are kept separate from the accounts of the owners.

Companies are jointly owned by the people who have invested in the business. These people buy shares in the company and they are therefore called **shareholders**. These shareholders appoint directors to run the business. In a private limited company, the directors are usually the most important or majority shareholders. This is usually not the case in a public limited company, as we shall see in the next section.

Definitions to learn

Incorporated businesses are companies that have separate legal status from their owners.

Shareholders are the owners of a limited company. They buy shares which represent part ownership of a company.

Case study example

Mike and Gita asked the solicitor to list the benefits of forming a private limited company:

Advantages of a private limited company

- Shares can be sold to a large number of people (in some countries there is a maximum number). These would be likely to be friends or relatives of Mike and Gita – they could not advertise the shares for sale to the general public. The sale of shares could lead to much larger sums of capital to invest in the business than the two original partners could manage to raise themselves. The business could therefore expand more rapidly.
- All shareholders have limited liability. This is an important advantage. It means that if the company failed with debts owing to creditors, the shareholders could not be forced to sell their possessions to pay the debts. The shareholders could only lose their original

investment in the shares – their liability is limited to the original investment. Shareholders in a company have less risk than sole traders and partners. Limited liability encourages people to buy shares, knowing that the amount they pay is the maximum they could lose if the business is unsuccessful. It is important that the people and other businesses that deal with a private limited company know that it is not a sole trader or a partnership. Creditors, for example, need to be aware that if the business did fail, then they could not take the owners to court to demand payment from their savings. For this reason all private limited company names must end with 'Limited', or 'Ltd' as an abbreviation. In some countries, although not the UK, this title is amended to 'Proprietary Limited' or '(Pty) Ltd'.

- The people who started the company – Mike and Gita in our example – are able to keep control of it as long as they do not sell too many shares to other people.

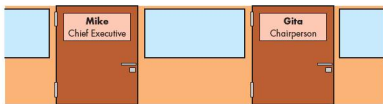
The solicitor was keen for Mike and Gita to know exactly what they would be committed to if they formed a private limited company. She also listed the disadvantages.

Disadvantages of a private limited company

- There are significant legal matters which have to be dealt with before a company can be formed. In particular, two important forms or documents have to be sent to the Registrar of Companies.
- *The Articles of Association* – This contains the rules under which the company will be managed – the rights and duties of all of the directors; rules concerning the election of directors and the holding of official meetings; and the procedure to be followed for the issuing of shares.
- *The Memorandum of Association* – This contains very important information about the company and the directors. The official name and the address of the registered offices of the company must be stated. The objectives of the company must be stated as well as the number of shares to be bought by each of the directors.
- Both of these documents are intended to make sure that companies are correctly run and to reassure shareholders about the purpose and structure of the company. Once these documents have been received by the Registrar of Companies, then a Certificate of Incorporation will be issued to allow the company to start trading.
- The shares in a private limited company cannot be sold or transferred to anyone else without the agreement of the other shareholders. This rule can make some people reluctant to invest in such a company because they may not be able to sell their shares quickly if they require their investment back.
- The accounts of a company are less secret than for either a sole trader or a partnership. Each year the latest accounts must be sent to the Registrar of Companies and members of the public can inspect them. Mike and Gita have to be prepared to allow more information about their business to be known to other people.
- Most importantly for rapidly expanding businesses, the company cannot offer its shares to the general public. Therefore it will not be possible to raise really large sums of capital to invest back into the business.

Private limited companies – how suitable is this form of organisation?

Mike and Gita were impressed by the benefits of a private limited company form of organisation. The solicitor told them it was a very common form of organisation for family businesses or partnerships when the owners wished to expand them further AND wanted to reduce the risk to their own capital. Private limited company status allows more capital to be raised – and this is often sufficient for all but the largest businesses. The solicitor offered to help Mike and Gita fill out the necessary legal forms to turn their business into a private limited company.

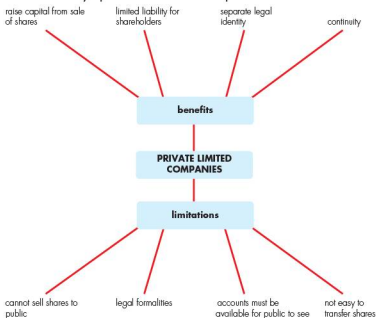


As directors of the private limited company, both Mike and Gita have very important roles

Tips for success

When answering questions that refer to 'companies' then the business must be either a private limited or public limited company. The term 'companies' should not be used when referring to sole traders or partnerships.

Revision summary: private limited companies



Public limited companies

This form of business organisation is most suitable for very large businesses. Most large, well-known businesses are public limited companies as they have been able to raise the capital to expand nationally or even internationally.

Students often make two mistakes about public limited companies:

- 1 Public limited companies are not in the public sector of industry as many students believe. They are not owned by the government but by private individuals and as a result they are in the private sector.
- 2 The title given to public limited companies can cause confusion. This is why in the UK, public limited companies are given the title 'plc' after the business name, for example J Sainsbury plc. In other countries, the title 'Limited' is used. This must not be confused with the UK use of 'Limited' which refers only to private limited companies.

The table below might help.

Private sector companies

| | Private limited companies | Public limited companies |
|---------------------------------------|----------------------------------|--------------------------|
| UK | Limited or Ltd | plc |
| South Africa and some other countries | Proprietary Limited or (Pty) Ltd | Limited |

Do not worry about the different terms used. In the Cambridge IGCSE® examinations, the questions will make it clear what type of company is being referred to.

Case study example

Express Taxis Ltd had been operating and expanding for many years. The two directors, Mike and Gita, still owned most of the shares. The company owned 150 taxis and had diversified into bus services. It owned 35 buses. The Government had recently announced the privatisation of all bus services in the country. Both Mike and Gita were determined to expand the business further by buying many of these bus routes from the Government. Many new buses would be needed. A huge investment of around \$90 million would be needed. Although profitable, the private limited company could not afford this sum of money.

Mike and Gita went to see a specialist business financial consultant at a large bank. The consultant was impressed by the directors' plans and advised them to convert their company into a public limited company. He explained the procedure for doing this and the benefits and drawbacks of this change.

Activity 4.2: Amin forms a limited company

Read Activity 4.1 again. Amin decided not to form a partnership with his uncle. Instead, 5 years after setting up his business, he is thinking of forming a private limited company. Amin would sell shares in this new company to friends and relatives but he wants to keep most shares himself. He is very busy repairing computers and fitting new computer systems for the large number of customers who appreciate Amin's IT skills and like the personal service he offers. He wants to raise capital to pay for a bigger workshop and two new vans. He plans to employ at least two other IT engineers. Amin is also thinking of recruiting a manager to help him deal with customers and the accounting side of the business. Amin has been told that when he creates a private limited company his 'personal risk will be reduced but that he will still own most of the business'.

- Identify and explain two advantages and two disadvantages to Amin of converting his business into a private limited company.
- Do you think that a private limited company is the appropriate form of organisation for Amin's business? Justify your answer.

A public limited company has certain advantages and disadvantages

Advantages of a public limited company

- This form of business organisation still offers **limited liability** to shareholders.
- It is an **incorporated business** and is a separate legal unit. Its accounts are kept separately from those of the owners and there is continuity should one of the shareholders die.
- There is now the opportunity to raise very **large capital sums** to invest in the business. There is no limit to the number of shareholders a public limited company can have.
- There is no restriction on the **buying, selling or transfer** of shares.
- A business trading as a public limited company usually has high status and should find it easier to attract suppliers prepared to sell goods on credit and banks willing to lend to it than other types of businesses.

Disadvantages of a public limited company

- The **legal formalities** of forming such a company are quite complicated and time consuming.
- There are many **more regulations and controls** over public limited companies in order to try to protect the interests of the shareholders. This includes the publication of accounts, which anyone can ask to see.
- Some public limited companies grow so large that they become **difficult to control and manage**.
- **Selling shares to the public is expensive**. The directors will often ask a specialist merchant bank to help them in this process. It will charge a commission for its services. The publication and printing of thousands of copies of the prospectus is an additional cost.
- There is a very real danger that although the original owners of the business might become rich by selling shares in their business they may **lose control** over it when it 'goes public'. This is an important point which we will investigate further.

Control and ownership in a public limited company

In all sole trader businesses and partnerships the owners have control over how their business is run. They take all the decisions and try to make the business achieve the aims that they set. This is also the case in most private limited companies which have relatively few shareholders. The directors are often the majority shareholders so they can ensure that their decisions are passed at all meetings.

With a public limited company the situation is very different. There are often thousands of shareholders – even millions in the case of the largest companies. It is impossible for all these people to be involved in taking decisions – although they are all invited to attend the **Annual General Meeting (AGM)**. The only decision that shareholders can have a real impact on at the AGM is the election of professional managers as company directors. They are given the responsibility of running the business and taking decisions. They will only meet with the other shareholders at the annual AGM. The directors cannot possibly control all of the business by themselves so they appoint other managers, who may not be shareholders at all, to take day-to-day decisions. The diagram below explains this situation.

Definitions to learn

An **Annual General Meeting** is a legal requirement for all companies. Shareholders may attend and vote on who they want to be on the Board of Directors for the coming year.



Control and ownership in a public limited company

Definitions to learn

Dividends are payments made to shareholders from the profits (after tax) of a company. They are the return to shareholders for investing in the company.

So, the shareholders own, but the directors and managers control. Sometimes, this is called the divorce between ownership and control.

Does this matter? It might be important for the shareholder. It means that the directors and managers may run the business to meet their own objectives. These could be increased status, growth of the business to justify higher management salaries, or reducing **dividends** to shareholders to pay for expansion plans. The shareholders are not able to influence these decisions – other than by replacing the directors at the next AGM. Doing this would give the company very bad publicity and cause the business to be unstable as the new directors may be inexperienced.



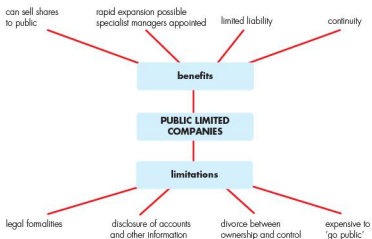
Mike and Gita now have to explain the performance of the company to a large number of shareholders at the AGM

Case study example

Mike and Gita had decided to convert the company into a public one – Express Taxi and Bus plc. By selling shares in their company, they had not only raised the capital they needed but they had also become very rich. They were elected as directors at the first AGM for the new plc. The expansion into buying the privatised bus companies was successful – at first. Profits rose and management salaries did too. However, new bus competitors were forcing bus fares down. Profits started to fall. The accounts published last year showed the lowest profits for three years. Mike and Gita were voted off the Board of Directors. They no longer had a majority of the shares – when it was a private limited company they owned 50 per cent of the shares each. Since 'going public', they owned only 20 per cent of the total shares issued. They had lost control of what had been their business. The new directors owned few shares. They cut dividends to shareholders and announced a new expansion programme to increase profits.

Mike and Gita were rich but they no longer controlled the business that had once belonged just to them. Mike missed being in control. He was thinking of setting up his own business by buying a luxury hotel. He planned to operate as a sole trader!

Revision summary: public limited companies



Activity 4.3

- How does the existence of limited liability benefit an individual shareholder?
- Does limited liability make it easier or more difficult for companies to attract new shareholders? Explain your answer.
- Explain why a sole trader might not want to convert the business into a partnership.
- It is possible to convert a public limited company back into a private limited company. This is done by individuals buying up a majority of the shares. Richard Branson did this several years ago with the Virgin Group. Why might Mike and Gita have wanted to do this with the Express Taxi and Bus plc?

Risk, ownership and limited liability – summary

| Business organisation | Risk | Ownership | Limited liability |
|-------------------------|--|---|-------------------|
| Sole Trader | Carried by sole owner | One person | No |
| Partnership | Carried by all partners | Several partners | No |
| Private Limited Company | Shareholders up to their original investment | Shareholders – may be few or many but shares cannot be sold to the public | Yes |
| Public Limited Company | Shareholders up to their original investment | Shareholders – many (may be millions!) | Yes |

Other private sector business organisations

Two other types of private sector business organisation exist.

Joint ventures

A joint venture is when two or more businesses agree to start a new project together, sharing the capital, the risks and the profits. Many European companies have set up joint ventures in China with Chinese businesses, as the local managers will have good knowledge of market needs and consumer tastes.

| Advantages of joint ventures | Disadvantages of joint ventures |
|---|--|
| Sharing of costs – very important for expensive projects such as new aircraft | If the new project is successful, then the profits have to be shared with the joint venture partner. |
| Local knowledge when joint venture company is already based in the country | Disagreements over important decisions might occur |
| Risks are shared. | The two joint venture partners might have different ways of running a business – different cultures |

Case study: Walmart's joint venture in India

Walmart is the world's largest retail business. The company wanted to enter the Indian market for the first time in 2009. Walmart did not set up its own stores initially as it had little knowledge of the Indian market or Indian consumers. Walmart set up a joint venture with Bharti Enterprises, one of India's largest business groups. The joint venture set up a business called BestPrice Modern Wholesale which sells vegetables to hotels, restaurants and shops. One day, Walmart might open their own named stores in India – as it has in many Asian countries.



Activity 4.4

Read the case study on page 46.

- What is meant by 'joint venture'?
- Identify and explain two benefits to Walmart of setting up a joint venture to enter the Indian market.
- Identify and explain two problems that Walmart might have in future if it opens its own stores in India.

Definitions to learn

A **franchise** is a business based upon the use of the brand names, promotional logos and trading methods of an existing successful business. The franchisee buys the licence to operate this business from the franchisor.

Tips for success

Many well known international businesses (multinational corporations) use franchising as a way of expanding into new foreign markets. The combination of a large well-known business and the local knowledge of the franchisees can lead to very successful operations.

Franchising

This is now an extremely widespread form of business operation. The franchisor is a business with a product or service idea that it does not want to sell to consumers directly. Instead, it appoints franchisees to use the idea or product and to sell it to consumers. Two of the best known international examples of a **franchise** are McDonald's restaurants and The Body Shop.

| | To the franchisor | To the franchisee |
|----------------------|---|---|
| Advantages | <ul style="list-style-type: none"> The franchisee buys a licence from the franchisor to use the brand name. Expansion of the franchised business is much faster than if the franchisor had to finance all new outlets. The management of the outlets is the responsibility of the franchisee. All products sold must be obtained from the franchisor. | <ul style="list-style-type: none"> The chances of business failure are much reduced because a well-known product is being sold. The franchisor pays for advertising. All supplies are obtained from a central source – the franchisor. There are fewer decisions to make than with an independent business – prices, store layout and range of products will have been decided by the franchisor. Training for staff and management is provided by the franchisor. Banks are often willing to lend to franchisees due to relatively low risk. |
| Disadvantages | <ul style="list-style-type: none"> Poor management of one franchised outlet could lead to a bad reputation for the whole business. The franchisee keeps profits from the outlet. | <ul style="list-style-type: none"> Less independence than with operating a non-franchised business. May be unable to make decisions that would suit the local area – e.g. new products that are not part of the range offered by the franchisor. Licence fee must be paid to the franchisor and possibly a percentage of the annual turnover. |



Franchised businesses give benefits to both the franchisor and the franchisee – but they must both contribute too

Business organisations in the public sector

The public sector is a very important part of the economy of all mixed economies. The term 'public sector' includes all businesses owned by the state and local government, public services, such as hospitals, schools and the fire services, and government departments.

Public corporations

These are wholly owned by the state or central government. They are usually businesses which have been nationalised. This means that they were once owned by private individuals, but were purchased by the government. Examples of these in many countries include water supply and rail services – but, as we saw in Chapter 2, even these businesses are now being privatised in many countries.

Public corporations are owned by the government but it does not directly operate the businesses. Government ministers appoint a Board of Directors, who will be given the responsibility of managing the business. The government will, however, make clear what the objectives of the business should be. The directors are expected to run the corporation according to these objectives.

Advantages of public corporations

- Some industries are considered to be so important that government ownership is thought to be essential. This includes water supply and electricity generation in many countries.
- If industries are controlled by monopolies because it would be wasteful to have competitors – two sets of railway lines to a certain town, for example – then these natural monopolies are often owned by the government. It is argued that this will ensure that consumers are not taken advantage of by privately owned monopolists.
- If an important business is failing and likely to collapse, the government can step in to nationalise it. This will keep the business open and secure jobs.
- Important public services, such as TV and radio broadcasting, are often in the public sector. Non-profitable but important programmes can still be made available to the public.

Disadvantages of public corporations

- There are no private shareholders to insist on high profits and efficiency. The profit motive might not be as powerful as in private-sector industries.
- Government subsidies can lead to inefficiency as managers will always think that the government will help them if the business makes a loss. It may also be unfair if the public corporation receives a subsidy but private firms in the same industry do not.
- Often there is no close competition to the public corporations. There is therefore a lack of incentive to increase consumer choice and increase efficiency.
- Governments can use these businesses for political reasons, for example to create more jobs just before an election. This prevents the public corporations being operated like other profit-making businesses.

Other public sector enterprises

Local government authorities or municipalities usually operate some trading activities. Some of these services are free to the user and paid for out of local taxes, such as street lighting and schools. Other services are charged for and expected to break even at least. These might include street markets, swimming pools and theatres. If they do not cover their costs, a local government subsidy is usually provided. In order to cut costs and reduce the burden on local taxpayers, an increasing range of services is now being privatised, so reducing the role of local government in providing goods and services.



Examples of other public sector enterprises

International business in focus: private companies 'go public'

TD Power Systems was incorporated as a private limited company in India in 1999. It has slowly expanded its range of advanced electric generators. By 2011 the company needed more capital to:

- pay back debt
- invest in a huge expansion of its factory in Dabaspet.

The private shareholders decided to sell at least 25 per cent of their shares and convert the business into a public limited company. This decision raised the capital needed.

Reva Medical makes medical equipment in San Diego, US. The owners were keen to take the business 'public' to raise capital for new research into heart medicine equipment. There was little interest from shareholders in the US – they were worried the profits from the new equipment would take several years to be earned. Reva's directors looked abroad – and decided on converting into a public company in Australia! The sale of shares on the Australian Stock Market allowed the company to raise the finance needed.

The owners of some young businesses have decided against 'going public' because of the cost involved, the loss of control and the need to make more information public.

Discussion points

- Do you think it would be better to keep a business such as TD Power Systems as a private company or convert it into a public limited company?
- Why are some business owners reluctant to convert their companies into public limited companies?



Share prices in public limited companies can fluctuate daily

Exam-style questions – Paper 1

- 1 When Jameel lost his job with a fruit and vegetable shop that closed down he decided to open his own store. He had good contacts with suppliers. They said they would give him one month's credit before he paid for supplies. Jameel had \$5000 in savings to invest in the shop. He thought this would be sufficient to start the business. He is an independent man – he never liked taking the manager's orders in the food shop! He wanted to operate his new business as a sole trader.
- What is meant by 'sole trader'? [2]
 - Identify **two** other types of business organisation. [2]
 - Identify and explain **two** benefits to Jameel of operating his business as a sole trader. [4]
 - Identify and explain **two** drawbacks to Jameel of operating his business as a sole trader. [6]
 - Do you think Jameel should open new branches of his business by selling franchises? Justify your answer. [6]
- 2 Aurelie and Nadine set up the A and N Partnership ten years ago. It specialises in handmade shoes and boots. The business now employs around 20 people. Demand for these products is increasing rapidly. The partners need to invest much more capital in the business but they need to avoid a lot of risk as they both have families dependent on the income made from the business. Their main competitor is ShoeWorks plc, which has a much larger market share than A and N and can afford extensive advertising.
- What is meant by 'partnership'? [2]
 - Identify **two** benefits to Aurelie and Nadine of the partnership legal structure. [2]
 - Identify and explain **two** possible benefits to ShoeWorks plc of being a public limited company. [6]
 - Identify and explain **two** drawbacks of the partnership form of legal structure to Aurelie and Nadine. [6]
 - If the A and N Partnership business continues recommend whether a private limited company is a suitable form of legal structure for this business. Justify your answer by considering the advantages and disadvantages of a private limited company. [6]

Revision checklist

In this chapter you have learned:

- the differences between sole trader and partnership organisations
- the differences between unincorporated businesses and limited companies
- the differences between private limited companies and public limited companies
- what franchising and joint ventures are
- the features of business organisations in the public sector
- how to recommend and justify suitable forms of business organisation to owners and managers in particular circumstances.

NOW – test your understanding with the revision questions on the CD-ROM.

Business objectives and stakeholder objectives

This chapter will explain the:

- the need for and importance of business objectives
- objectives that can be set for a business in the private sector including social enterprises
- business objectives in the public sector
- factors that influence which objectives are set
- different stakeholder groups with an interest in a business
- objectives of stakeholder groups
- potential conflict between objectives.

Definitions to learn

Business objectives are the aims or targets that a business works towards.

Business objectives – why set them?

An **objective** is an aim or a target to work towards. All businesses should have objectives. They help to make a business successful – although just setting an objective does not ‘guarantee success’. The benefits of setting objectives are:

- They give workers and managers a clear target to work towards and this helps motivate people.
- Taking decisions will be focused on: ‘Will it help achieve our objectives?’
- Clear and measurable objectives help unite the whole business towards the same goal.
- Business managers can compare how the business has performed with their objectives – to see if they have been successful or not.

So setting objectives is very important for all businesses – small or large, newly formed or well established.

What objectives do businesses set?

Objectives are often different for different businesses. A business may have been formed by an entrepreneur to provide employment and security for the owner or his/her family. It could have been started to make as big a profit as possible for the owner. On the other hand, the business might have a more charitable aim in mind – many of the leading world charities are very large businesses indeed.

The most common objectives for businesses in the private sector are to achieve:

- business survival
- profit
- returns to shareholders
- growth of the business
- market share
- service to the community.

Survival

When a business has recently been set up, or when the economy is moving into recession, the objectives of the business will be more concerned with survival than

anything else. New competitors can also make a firm feel less secure. The managers of a business threatened in this way could decide to lower prices in order to survive, even though this would lower the profit on each item sold.

Profit

When a business is owned by private individuals rather than the government it is usually the case that the business is operated with the aim of making a **profit**. The owners will each take a share of these profits. Profits are needed to:

- **pay a return** to the owners of the business for the capital invested and the risk taken
- **provide finance** for further investment in the business.

Without any profit at all, the owners are likely to close the business.

Will a business try to make as much profit as possible? It is often assumed that this will be the case. But there are dangers to this aim. Suppose a firm put up its prices to raise profits. It may find that consumers stop buying their goods. Other people will be encouraged to set up in competition, which will reduce profits in the long term for the original business.

It is often said that the owners of a business will aim for a satisfactory level of profits which will avoid them having to work too many hours or paying too much in tax to the government.

Returns to shareholders

Shareholders own limited companies (see Chapter 4). The managers of companies will often set the objective of 'increasing returns to shareholders'. This is to discourage shareholders from selling their shares and it helps managers to keep their jobs!

Returns to shareholders are increased in two ways:

- **increasing profit** and the share of profit paid to shareholders as dividends
- **increasing share price** – managers can try to achieve this not just by making profits but by putting plans in place that give the business a good chance of growth and higher profits in future.

Growth

The owners and managers of a business may aim for growth in the size of the business – usually measured by value of sales or output – for a number of reasons:

- to make jobs more secure if the business is larger
- to increase the salaries and status of managers as the business expands
- to open up new possibilities and help to spread the risks of the business by moving into new products and new markets
- to obtain a higher market share from growth in sales
- to obtain cost advantages, called economies of scale, from business expansion.

These are considered in more detail in Chapter 18.

Growth will only be achieved if the business's customers are satisfied with the products or services being provided. For this reason it might be important to put meeting customers' needs as a very high priority.

Definitions to learn

Profit is total income of a business (sales revenue) less total costs.

Definitions to learn

Market share is the proportion of total market sales achieved by one business.
A social enterprise has social objectives as well as an aim to make a profit to reinvest back into the business.

Market share

If the total value of sales in a market is \$100 million in one year and Company A sold \$20 million, then Company A's **market share** is 20 per cent.

$$\text{Market share \%} = \frac{\text{Company sales}}{\text{Total market sales}} \times 100$$

Increased market share gives a business:

- good publicity, as they could claim that they are becoming 'the most popular'
- increased influence over suppliers, as they will be very keen to sell to a business that is becoming relatively larger than others in the industry
- increased influence over customers (for example, in setting prices).

Providing a service to society

Social enterprises are operated by private individuals – they are in the private sector – but they do not just have profit as an objective. The people operating the social enterprise often set three objectives for their business:

- **social:** to provide jobs and support for disadvantaged groups in society, such as the disabled or homeless
- **environmental:** to protect the environment
- **financial:** to make a profit to invest back into the social enterprise to expand the social work that it performs.

An example of a social enterprise is RangSutra in India. This helps very poor village communities develop skills in craft work and clothing products and helps them market their products at a fair price.



A display of RangSutra products. RangSutra's core value is 'respect for both the producer and customer'. They ensure a fair price to the producer as well as quality products to the customer. Profits earned from sales go back to ensure a better life for their communities, as the producers are also the owners of RangSutra.

Why business objectives could change

It is most unusual for a business to have the same objective forever! Here are some examples of situations in which a business might change its objective.

- 1 A business set up recently has survived for three years and the owner now aims to work towards higher profit.
- 2 A business has achieved higher market share and now has the objective of earning higher returns for shareholders.
- 3 A profit-making business operates in a country facing a serious economic recession so now has the short-term objective of survival.

Tips for success

Do not suggest that 'making as much profit as possible' is always the most likely objective of a business. It might depend on economic conditions and the original aims of the owners – for example, they could have been more focused on helping groups in society than making money.

Activity 5.1: Which objective for which business?

Here are brief details of four businesses.

- A small firm of builders which has noticed new businesses being set up in the building industry.
 - A recently established business in the rapidly expanding computer industry, which is owned by two young and ambitious entrepreneurs.
 - A large book publishers which dominates the market in textbooks in your country.
 - A group of people who are concerned about the lack of clean water provided to poor communities.
- a) Identify and explain the most likely main objective of the managers of each of these businesses.
 - b) In each example, explain the decisions that could help the businesses to achieve these objectives.

Which stakeholder groups are involved in business activity?

The following groups of people are involved in business activity in one way or another, or are affected by it:

- owners
- consumers
- workers
- government
- managers
- banks
- the whole community.

These groups are sometimes called the **stakeholders** of the business as they have an interest in how the business is run. Some of these groups are internal to the business – they work for it or own it – and others are external – they are groups outside of the business.

Why are these groups of people important to business? How are they affected by business activity? Consider the table on page 56.

Definitions to learn

A **stakeholder** is any person or group with a direct interest in the performance and activities of a business.

Business objectives and stakeholder objectives

| Stakeholder group | Main features | Most likely objectives for the stakeholder group |
|--------------------------------|---|--|
| Owners (Internal) | <ul style="list-style-type: none"> They put capital in to set up and expand the business. They will take a share of the profits if the business succeeds. If the business does not attract enough customers, then they may lose the money they invested. They are risk takers. | <ul style="list-style-type: none"> share of the profits so that they gain a rate of return on the money put into the business growth of the business so that the value of their investment increases |
| Workers (Internal) | <ul style="list-style-type: none"> They are employed by the business; they are also called employees. They have to follow the instructions of managers and may need training to do their work effectively. They may be employed on full- or part-time contracts and on a temporary or permanent basis. If there is not enough work for all workers, some may be made redundant (retrenchment) and told to leave the business. | <ul style="list-style-type: none"> regular payment for their work contract of employment job security – workers do not want to look for new jobs frequently job that gives satisfaction and provides motivation |
| Managers (Internal) | <ul style="list-style-type: none"> They are also employees of the business and control the work of other workers. They take important decisions. Their successful decisions could lead to the business expanding. If they make poor decisions, the business could fail. | <ul style="list-style-type: none"> high salaries because of the important work they do job security – this depends on how successful they are growth of the business so that managers can control a bigger and better known business. This gives them more status and power |
| Customers (External) | <ul style="list-style-type: none"> They are important to every business. They buy the goods that the business produces or the services that the business provides. Without enough customers, a business will make losses and will eventually fail. The most successful businesses often find out what consumers want before making goods or providing services – this is called market research. | <ul style="list-style-type: none"> safe and reliable products value for money well-designed products of good quality reliability of service and maintenance |
| Government (External) | <ul style="list-style-type: none"> They are responsible for the economy of the country. They pass laws to protect workers and consumers. | <ul style="list-style-type: none"> want businesses to succeed in their country. Successful businesses will employ workers, pay taxes and increase the country's output expect all firms to stay within the law – laws affect business activity |
| The whole community (External) | <ul style="list-style-type: none"> The community is greatly affected by business activity. For example, dangerous products might harm the population. Factories can produce pollution that damages rivers, the sea and air quality. Businesses also create jobs and allow workers to raise their living standards. Many products are beneficial to the community, such as medicines or public transport. | <ul style="list-style-type: none"> jobs for the working population production that does not damage the environment safe products that are socially responsible |
| Banks (External) | <ul style="list-style-type: none"> They provide finance for the business's operations. | <ul style="list-style-type: none"> expect the business to be able to pay interest and repay capital lent – business must remain liquid |

Objectives of public-sector businesses

In Chapter 2 we explained that the government owns and controls many businesses and other activities in mixed economies. These were in the public sector. What are the likely objectives for public-sector businesses and organisations?

- **Financial:** Meet profit targets set by government – sometimes the profit is reinvested back in the business and on other occasions it is handed over to the government as the ‘owner’ of the organisation.
- **Service:** Provide a service to the public and meet quality targets set by government. For example, health services and education services will be expected to achieve targets laid down for them, and state-owned train and postal services will have reliability and punctuality targets.
- **Social:** Protect or create employment in certain areas – especially poor regions with few other business employers.

Tips for success

You should not suggest that public-sector businesses ‘do not want to make a profit’. Most of them do have this aim – but they have other objectives set for them by governments too.

Revision summary: business objectives (private sector)



Activity 5.2: Coca-Cola's objectives

Coca-Cola's senior managers have set the objective of increasing returns to owners of the company – that is, its millions of shareholders. However, the managers believe that this can only be achieved if Coca-Cola meets three other objectives.

- Remain the world's largest soft drinks company by value of sales.
 - Continue to satisfy consumers with a top-value and clearly branded product.
 - Protect the environment of the local communities where Coca-Cola drinks are made.
- a) Why do you think the senior managers believe that 'increasing returns to owners' is important?

(continued)

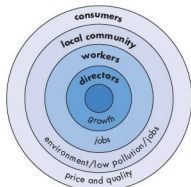
Activity 5.2: Coca-Cola's objectives (continued)

- b) Explain why Coca-Cola has set three other objectives as well as 'returns to owners'?
- c) By referring to the market in your own country, explain how you think Coca-Cola could achieve its aim of remaining the world's largest soft drinks company.



Conflict of stakeholders' objectives

In the previous section we assumed that businesses could set one objective and aim for that. However, life is not that simple and most businesses are trying to satisfy the objectives of more than one group, as the diagram below shows.



Case study example – business stakeholders

Oilco is a large oil company operating in your country. The following stakeholder groups are interested in the work of this company.

- **Owners of the company.** They are likely to want the business to work towards as much profit as possible.
- **Directors** (senior managers of the company appointed by the owners). They will be interested in growth of the business as their salaries are likely to depend on this.
- **Workers.** They will want as many jobs as possible with security of employment.
- **Local community.** It will be concerned about jobs too, but it will also be worried about pollution from the oil refinery.
- **Consumers.** They will want reasonably priced products of appropriate quality – or they may buy goods from competitors.

In practice, these stakeholder objectives could conflict with each other. For example:

- it could be that a cheap method of production increases profits but causes more pollution
- a decision to expand the plant could lead to a dirtier, noisier local environment
- a decision to introduce new machines could reduce the jobs at the refinery but lead to higher profits
- expansion could be expensive, reducing payments to owners, and this could reduce short-term profits.

Managers therefore have to compromise when they come to decide on the best objectives for the business they are running. They would be unwise to ignore the real worries or aims of other groups with an interest in the operation of the business. Managers will also have to be prepared to change the objectives over time. Growth could be the best option during a period of expansion in the economy, but survival by cost cutting might be better if the economy is in recession.

Activity 5.3

Read the case study on page 58.

- What is meant by 'stakeholder group'?
- Identify and explain one other possible conflict of objectives between Oilco's stakeholders.

Tips for success

Be prepared to explain how a business objective might satisfy some stakeholders but not others.

Revision summary: business stakeholders and their aims



International business in focus: Toyota makes clear its business objectives

The President of Toyota, recently announced the targets for the business over the next few years. The key objective is sales growth. Sales of 10 million cars and trucks by 2016 is the main target. Toyota wants to achieve 50 per cent of these sales in the 'emerging economies' of Asia, Africa and South America.

Although profits are important, Toyota has set quite low earnings targets, preferring to focus on growth in a competitive market – especially at a time when the global economy is so troubled by debt problems and fear of recession in some major countries. The company also has the aim of developing ten more hybrid models over the next five years (hybrid cars are powered by petrol and electricity).

'Our two main pillars of growth in the future will be emerging markets and hybrid vehicles. We cannot sit on our laurels in order to stay the market leader in hybrids', Mr Toyoda said.

Discussion points

- Why did the Toyota President think it necessary to set objectives for Toyota for the next few years?
- Why do you think sales growth and developing new models seem to be more important than 'making as much profit as possible'?
- Which stakeholder groups will be affected – positively or negatively – by Toyota working towards these objectives?



One of Toyota's objectives is to produce and sell more hybrid cars

Exam-style questions – Paper 1

- 1 Sunita and her partner Sunil decided to start a business selling flowers called S and S Blooms. They agreed on the business objectives they would set. There are several other shops in their town and there is much competition. Sunita and Sunil had very little cash to start their shop. However, five years after being set up, it is still open. Business objectives have changed. There are plans to open two or three more shops – perhaps by taking over some of their competitors. The business now employs five workers and uses several local flower growers as suppliers.
- What is meant by 'business objective'? [2]
 - Identify **two** of S and S Blooms' stakeholder groups, other than workers and suppliers. [2]
 - Identify and explain **two** likely business objectives for S and S Blooms when the business was first established. [4]
 - Identify and explain **two** likely reasons why Sunita and Sunil have changed the business objectives of S and S Blooms. [6]
 - Do you think that setting business objectives for S and S Blooms will make sure that the business is successful? Justify your answer. [6]
- 2 The Big Pit Mining business (BPM) owns and operates coal and gold mines in several different countries. It employs thousands of workers. Most of them work in very dangerous conditions for low pay. Rubbish from the mines is often dumped in local rivers. 'Making higher profits and raising returns to our shareholders are our most important objectives', said the Managing Director of BPM to his other senior managers recently. 'Shareholders are our most important stakeholder group', he added.
- What is meant by 'stakeholders'? [2]
 - Identify **two** objectives that the managers might set for BPM, apart from profits and returns to shareholders. [2]
 - Identify and explain **two** possible reasons why BPM has profit as an objective. [4]
 - Identify and explain how a decision to open a new BPM mine might affect **two** stakeholder groups. [6]
 - Do you agree with the Managing Director when he said that shareholders are the most important stakeholder group? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- why a business needs objectives and the different objectives that can be set
- the objectives of public-sector organisations
- what stakeholder groups are and the objectives they have
- the potential for conflicts between objectives.

NOW – test your understanding with the revision questions on the CD-ROM.

Understanding business activity: end of section case study (Paper 2 style)

A new business but which one?



Derek's job is to repair motorcycles. He works for a large motorcycle sales business that sells new and second-hand motorcycles. Derek's uncle died earlier this year and left him \$10 000. He has always wanted to work for himself and now he has some money to start his own business. He could do this by opening his own business or buying a franchise.

Derek is going to choose between opening his own motorcycle shop selling

motorcycle clothes or buying a franchise from a big motorcycle clothes retail business. To open his own motorcycle clothes shop will take a lot of effort to find a suitable location with the shop fittings needed. Buying a franchise for a clothes shop will be expensive. However, the franchise company will help Derek with a lot of the start up problems such as finding a suitable shop.

Appendix 1: letter to bank manager

Dear Sir/Madam

I want to set up my own business. I have \$10 000 to invest in my business but I need additional funds. I have two possible business ideas.

The first one is to set up my own motorcycle clothes shop and for that I will need an additional \$15 000 to buy clothes for the shop. I will rent my shop.

The second idea is to buy a franchise for a motorcycle clothes shop and for that I will need an additional \$100 000. \$50 000 will be needed to buy the franchise and \$50 000 to buy clothes inventories. I will rent my shop.

I would like to come to see you to discuss my two ideas.

Yours faithfully,

Derek

- 1 a) Identify and explain **four** personal characteristics that Derek needs to be a successful entrepreneur. [8]

b) Derek has to decide which type of business organisation to choose if he sets up his own business. Consider the advantages and disadvantages of the following types of business organisation. Recommend which one Derek should choose. Justify your choice.

 - Sole trader.
 - Partnership.
 - Private limited company. [12]
- 2 a) Identify **two** stakeholders in Derek's new business. Explain why each stakeholder is interested in his business. [8]

b) Consider the advantages and disadvantages to Derek of buying a franchise from a big clothes retail business instead of setting up his own clothes shop. Which option do you think he should take? Justify your choice. [12]

Section

2

People in business

Chapters

- 6 Motivating workers
- 7 Organisation and management
- 8 Recruitment, selection and training of workers
- 9 Internal and external communication



6

Motivating workers

This chapter will explain:

- why people work and motivation theories
- what are the factors that motivate workers (financial and non-financial rewards)
- job satisfaction.

Definitions to learn

Motivation is the reason why employees want to work hard and work effectively for the business.

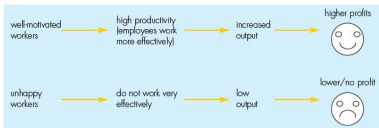
Why people work

People work for a variety of reasons. The main reason why most people work is because they need to earn money to buy food and the basic necessities for life. But some work is voluntary and does not yield any money. This chapter considers a wide range of **motivations** for work and how firms can make use of this motivation to encourage their workers to work more effectively. High productivity in a business usually comes from a workforce that is motivated to work effectively and from this comes increased profits. It also considers leadership styles which might be used by managers, the effect of trade unions on the workers and legal considerations when employing workers.

The reasons why people work are summarised in the diagram below.



Of course, improved organisation in a business and/or the increasing use of new technology, especially when it replaces workers, result in productivity gains. However, businesses also need to recognise that the value of their employees' output, in terms of how much they produce and the quality of it, comes from how well motivated they are to work effectively. Employees are a firm's greatest asset!



Motivation theories

When people work for themselves they tend to work hard and effectively as they see the direct benefits of their labours. However, once people work for someone else then they may not work as effectively. One of the tasks of management is to get their workforce to contribute fully to the success of the business. To this end, many studies have been carried out to discover what makes employees work effectively. Three main theories are outlined on the following pages.

F.W. Taylor

Frederick Taylor started his working life as a labourer in a factory in America in the 1880s. He rose to become chief engineer. During this time he conducted experiments, at the steel company where he worked, into how labour productivity could be increased. Taylor based his ideas on the assumption that all individuals are motivated by personal gain and therefore, if they are paid more, they will work more effectively. He was looking at workers who worked in factories. He broke down their jobs into simple processes and then calculated how much output they should be able to do in a day. If they produced this target output, they would be paid more money. Taylor saw employees rather like machines – when they were working hard, their productivity would be high and therefore their labour costs would be low. (Any extra output would be worth more than the extra pay the workers received.)

Taylor's ideas resulted in big productivity gains at the company where he worked and many other businesses adopted his ideas. But there are several criticisms of Taylor's ideas:

- his ideas were too simplistic – employees are motivated by many things and not just money
- you can pay an employee more money, but if they are unfulfilled by their work in some way, there will be no increase in their effectiveness at work and there will be no productivity gains
- a practical problem arises if you cannot easily measure an employee's output.

Activity 6.1

- a) From the following list of jobs, say what you could measure to find out how effectively the employees are working (how much output they are producing):
 - car production worker
 - shop assistant
 - waiter
 - teacher
 - police officer
 - soldier
 - baker.
- b) Are there any jobs from the list for which output is difficult to measure? If so, explain why it is difficult to measure their output in each case.
- c) If you cannot measure workers' output, how can you pay them more money if they work harder or more effectively?
- d) Does this present problems for modern economies today where the majority of the workforce work in service sector jobs?

Maslow

Abraham Maslow studied employee motivation. He proposed a hierarchy of needs, shown in this diagram.



Maslow's hierarchy of needs

- Businesses have begun to recognise that if employees are going to be motivated to work effectively then the higher levels in the hierarchy must be available to them – money alone will not be the single route to increased productivity as was thought by Taylor. Evidence for the hierarchy can be seen in people who are unemployed. They very often lose their self-respect and self-esteem and may not have the feeling of belonging to society, which often comes from working.
- Maslow also suggested that each level in the hierarchy must be achieved before an employee can be motivated by the next level. For example, once social needs are met, this will no longer motivate the employee, but the opportunity to gain the respect of fellow workers and to gain esteem could motivate the employee to work effectively. If this is true, then there are important messages for management in the way employees are managed.
- There are problems in that some levels do not appear to exist for certain individuals, while some rewards appear to fit into more than one level. For example, money allows basic needs to be purchased, but high pay can also be a status symbol or indicator of personal worth.
- Managers must identify the level of the hierarchy that a particular job provides and then look for ways of allowing the employees to benefit from the next level up the hierarchy. For example, workers in agriculture who work on a temporary basis, when required, will probably have physiological needs fulfilled, but security needs may be lacking. If they were offered full-time jobs, they might feel more committed to the business and work more effectively for it.

Activity 6.2

- Miguel works as a farm labourer for a rich landlord. He has a small house on the estate and is allowed to grow his own food on a piece of land next to his house. He grows enough food to feed himself and his family and is paid a small wage, which pays for the other needs of the family such as clothes, shoes and medicines.
- Pierre works in a car factory on the assembly line. He works in a team of other workers welding the car body together. He is also a member of the company football team. He is well paid and his family can afford quite a few luxuries.
- Anya has a degree in Business Management and professional qualifications in human resources management. She is the Human Resources Manager of a large company. She has her own office with her name on the door and is in charge of the rest of the human resources staff. She works long hours but feels it is worth it if the right employees are recruited to the company.

Identify which of Maslow's needs are being satisfied for each of these employees. Explain the reasons for your choices.

Herzberg

Frederick Herzberg's motivation theories were based on his study of work on engineers and accountants in the US. According to Herzberg, humans have two sets of needs; one is for the basic animal needs, which he called 'hygiene' factors or needs, and the second is for a human being to be able to grow psychologically, which he called 'motivational' needs or 'motivators'.

| |
|---|
| Motivators |
| achievement |
| recognition |
| personal growth/development |
| advancement/promotion |
| work itself |
| 'Hygiene' (or 'maintenance') factors |
| status |
| security |
| work conditions |
| company policies and administration |
| relationship with supervisor |
| relationship with subordinates |
| salary |

Tips for success

Make sure you can explain each of these theories and also explain how knowledge of them can help managers to improve the motivation of the employees.

According to Herzberg, the 'hygiene' factors must be satisfied; if they are not satisfied, they can act as demotivators to the worker. However, they do not act as motivators, as once satisfied the effects of them quickly wear off. True motivators are found in other factors, as shown in the table above.

Case study example

Company A employs 100 workers taking telephone orders and making calls to potential customers. The company thinks it treats its workers well. The offices they work in are well lit, warm but not too hot, the salary is similar to the pay in other similar jobs, the supervisors are polite and keep checking the work of the employees. The workers are told what to do and have no opportunities for promotion. There is no recognition of workers who have done well in their jobs. The management is worried because the workers do not seem to be particularly happy and have not increased their productivity. There is high labour turnover.

Activity 6.3

Read the case study above.

- Why do you think the workers might not be happy in their jobs?
- Suggest ways the management might increase the motivation of their employees.

People often say that money is the main motivator. It may not be. Surveys show that the other factors discussed above may be much more important to people than money alone. The lack of these other motivators is often a reason why employees leave a job and seek employment elsewhere.

Revision summary: motivation theories



Motivating factors – financial rewards/motivators

It is the responsibility of management, and often the Human Resources department, to motivate the workforce. A well-motivated workforce helps to raise productivity. Employees who are well motivated tend to have fewer days off work and are less likely to have grievances which result in strike action.

So how can managers motivate their employees – whether it be in the office or on the factory floor? There are three factors which can motivate employees:

- financial rewards
- non-financial rewards
- introducing ways to give job satisfaction.

Financial rewards

Pay may be seen as a main reason for working, but there are other reasons, as has been discussed in ‘Motivation theories’ on pages 65–68. However, pay may be used to give incentives to employees to encourage them to work harder or more effectively. Payment can take various forms, the most common of which are outlined below.

Wages

Wages are often paid every week, sometimes in cash and sometimes into a bank account.

- The worker gets paid on a regular basis and does not have to wait long for some money. Wages tend to be paid to manual workers, such as those who work in a warehouse.
- If the employee works longer than their normal hours, they can usually be paid overtime. This is their regular amount per hour plus an extra amount. This is an incentive to work additional hours when required by the business.

However, there are some drawbacks:

- As the wages are paid weekly, they have to be calculated every week, which takes time and money.
- Wages clerks are often employed to perform this task.

When calculating the wages to be paid, they can be worked out in a number of different ways.

Time rate

This is payment by the hour (payment for a period of time). For example, if an employee is paid \$10 per hour and they work for 40 hours, then they will be paid \$400.

- This makes it easy to calculate the worker’s wages and the worker knows exactly what they will be paid for working a certain period of time.

However, there are drawbacks:

- The hours worked are often recorded on a time-sheet which must be filled in and used to calculate the wages by the Accounts department. This system takes time.
- Good and bad workers get paid the same amount of money.
- Often supervisors are needed to make sure the workers keep working and producing a good quality product. This is expensive because more supervisors are needed by the business.
- A clocking-in system is needed to determine the number of hours worked by the employees.

Time rate is often used where it is difficult to measure the output of the worker, for example a bus driver or hotel receptionist.

Piece rate

This is where the workers are paid depending on the quantity of products made – the more they make, the more they get paid. A basic rate is usually paid with additional money paid according to how many products have been produced. Piece rate can be

Definitions to learn

A **wage** is payment for work, usually paid weekly.

Definitions to learn

A **salary** is payment for work, usually paid monthly.

Commission is payment relating to the number of sales made.

Profit sharing is a system whereby a proportion of the company's profits is paid out to employees.

A **bonus** is an additional amount of payment above basic pay as a reward for good work.

Performance-related pay is pay which is related to the effectiveness of the employee where their output can easily be measured.

Share ownership is where shares in the company are given to employees so that they become part owners in the company.

applied to bonus systems where employees who produce more than a set target of output can be rewarded. Piece rates can only be used where it is possible to measure the performance of an individual or a team.

- The advantage with this system is that it encourages workers to work faster and produce more goods.

However:

- Workers may concentrate on making a large number of products and ignore quality, producing goods that may not sell very well because they are of a poor quality. This usually requires a quality control system and this is expensive. If poor quality goods are produced, this could damage the reputation of the business.
- Workers who are careful in their work will not earn as much as those who rush, which may not be seen as fair. Friction between employees may be caused as some will earn more than others.
- If the machinery breaks down, the employees will earn less money. Because of this, workers are often paid a guaranteed minimum amount of money.

Salaries

Salaries are paid monthly, normally straight into a bank account. They are not paid in cash. It is usual for office staff or management (white-collar workers) to be paid salaries.

- A salary is calculated as an amount of money per year and is divided into 12 monthly amounts. This is easy to calculate salary costs for the business.
- It is paid for the job and extra work is not usually paid for – it is counted as part of the salary.
- The employer has the money in their bank account for longer than if they were paying their workers wages, as salaries are paid only once a month.
- The payment has to be calculated only once a month instead of at least four times a month – as with wages.

Salaries are usually a standard rate (a set amount of money) but workers may get more money if the following rewards are added to the basic salary: **commission**; **profit sharing**; **bonus**; **performance-related pay**; **share ownership**.

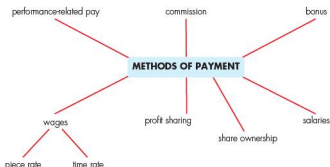
| | |
|-----------------------|--|
| Commission | Often paid to sales staff. The more sales they make the more money they are paid – similar to piece rate. This encourages the sales staff to sell as many products as possible. This should be good for the business as sales may increase. However, if the sales staff are very persuasive and encourage people to buy goods they don't really want, then the business may see its sales increase only in the short term and then fall again as it gets a bad reputation. It can be very stressful for the sales staff because if they have a bad month, their pay will fall. |
| Profit sharing | Employees receive a share of the profits in addition to their basic salary. This will motivate the workers to work hard as they all receive a share of the profits earned by the business. The rest of the profits will be paid as dividends to the shareholders or retained by the business. Profit sharing is often used in the service sector where it is difficult to identify an individual employee's contribution to the increased profits, but they will all benefit from more productive work. |
| Bonus | A lump sum paid to workers when they have worked well. It can be paid at the end of the year or at intervals during the year. |

Definitions to learn

An **appraisal** is a method of assessing the effectiveness of an employee.

| | |
|--------------------------------|---|
| Performance-related pay | Employee pay is linked to the effectiveness of their work. Again often used where output cannot readily be measured, for example police officers, teachers, managers or health workers. To assess their performance, businesses often use a system of appraisal . Appraisal is where an employee's immediate superior observes their work, talks to the worker's colleagues and then carries out an interview with the employee to discuss their progress and their effectiveness. Training needs may be identified at the appraisal interview and this should help to improve the employee's effectiveness in the future. |
| Share ownership | Employees are given some shares in the company. This should encourage them to work hard as they will receive dividends if the company does well. Also, the share price will increase if the company is doing well and so increase the value of their shares. May improve employee loyalty, as they will have a greater sense of being part of the company. |

Revision summary: methods of financial reward


Tips for success

Make sure you are able to choose suitable methods of payment for different jobs.

Motivating factors – non-financial rewards/motivators

In addition to financial rewards, firms may give non-financial rewards. Non-financial rewards vary according to the seniority of the job. Factory workers may get discounts on the firm's products, but they would not all have a company car, whereas a senior manager may have several non-financial rewards, such as a house, a car and an expense account. These are sometimes called perks or **fringe benefits** of a job. Non-financial rewards may include:

- company vehicle (car)
- discounts on the firm's products
- health care paid for
- children's education fees paid
- free accommodation
- share options (where company shares are given to employees)
- generous expense accounts (for food and clothing)
- pension paid for by the business
- free trips abroad/holidays.

Definitions to learn

Fringe benefits are non-financial rewards given to employees.

Activity 6.4

For the following jobs, say which methods of reward (financial or non-financial) would be suitable and why. (Remember to consider whether it is easy to measure their output – this may affect how you decide to reward their efforts.)

- car production worker
- hotel receptionist
- teacher
- shop assistant
- managing director
- taxi driver

Definitions to learn

Job satisfaction is the enjoyment derived from feeling that you have done a good job.

Tips for success

Make sure you are able to choose suitable fringe benefits (non-financial rewards) for different jobs.

Job satisfaction

There are other ways that people can be motivated to be more committed to their job and work more effectively – they need to get enjoyment from doing their job. However, there are some factors that will make employees unhappy and these must be satisfied before the employees can be motivated in a positive way. For example, if the management of the business is not good and the employees are treated badly, giving them fringe benefits will probably not motivate them. If their rates of pay are perceived by the employees as very low relative to those of other similar workers, this will be a source of dissatisfaction to the employees. If these sources of dissatisfaction have been avoided, for example if reasonable wage rates are paid and employees are treated fairly at work, then other sources of **job satisfaction** can motivate employees.

Employees have different ideas about what makes their jobs satisfying. They include:

- pay – the amount of money paid to an employee (see pages 69–71)
- opportunities for promotion
- working conditions
- fringe benefits or non-financial rewards (see page 71)
- the way that the employee is managed or treated
- working hours
- colleagues
- the nature of the work itself
- level of responsibility
- the sense of achievement derived from the job
- recognition for good work
- chance for training
- status of the job.

Individual employees will have different ideas about which of these is the most important.

Compare a nurse with a machine operator in a factory. What do you think makes their jobs satisfying? Copy out the table below and list your ideas for each.

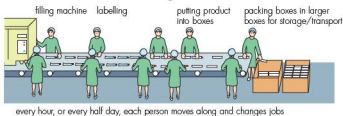
| Nurse | Machine operator |
|-------|------------------|
| | |
| | |
| | |

Some of the motivation theories (particularly Maslow and Herzberg) emphasise that the important aspects of jobs are that they should give recognition, responsibility and satisfaction to the people doing them and allow the employee to gain a sense of achievement from the work itself. Some jobs may seem dull and boring, but with a little thought and creativity they can be made more interesting and consequently increase motivation.

There are several ways in which a business can increase the job satisfaction of its employees.

Job rotation

Workers on a production line may carry out simple but different tasks. **Job rotation** involves the workers swapping round and doing each specific task for only a limited time (for example, for one hour) and then changing round again. This increases the variety in the work itself and also makes it easier for the managers to move workers around the factory if people are ill and their jobs need covering. However, it does not make the tasks themselves more interesting.



Job enlargement

Job enlargement is where extra tasks of a similar level of work are added to a worker's job description. The extra tasks should not add extra work or increased responsibility to the employee, but they should give greater variety to the work and therefore increase job satisfaction.



Definitions to learn

Job rotation

involves workers swapping round and doing each specific task for only a limited time and then changing round again.

Job enlargement is where extra tasks of a similar level of work are added to a worker's job description.

Definitions to learn

Job enrichment involves looking at jobs and adding tasks that require more skill and/or responsibility

Job enrichment

involves looking at jobs and adding tasks that require more skill and/or responsibility. Additional training may be necessary to enable the employee to take on extra tasks. For example, employees may be given responsibility for a whole area of the work. If managers can design jobs so that they provide scope for fulfilling higher human needs, workers will often become more committed because they get more satisfaction from their jobs, again raising productivity.



Autonomous work groups or teamworking

This is where a group of workers is given responsibility for a particular process, product or development. They can decide as a group how to complete the tasks or organise the jobs. The workers can become more involved in the decision making and take responsibility for this process. This gives a feeling of control over the jobs/tasks and the employees feel more committed, therefore increasing job satisfaction. An example of this way of organising employees is on a car production line where particular parts of the assembly line are given over to teams of workers and they decide how to organise themselves. Often this leads to job rotation and job enrichment. Working as a group helps improve morale as well as giving a greater sense of belonging to the company.



A team of workers is responsible for a particular part of the assembly
The team decides how the processes will be completed
The tasks are allocated by the team themselves - they make the decisions

Revision summary: motivating factors at all levels



Tips for success

Make sure you are able to choose suitable ways of increasing job satisfaction for different jobs.

Activity 6.5

- Duncan is a computer programmer. He has a degree in Computer Studies and enjoyed writing programs as part of his degree course. He thought computer programming would be his ideal job. However, all he does is write simple programs for firms' Accounts departments which allow the processing of their paperwork.
He is told what to do by his manager and is given little opportunity to visit the client to discuss their requirements and does not go to install the software at the business when it is finished. He is so fed up he is looking for another job.
- Sita works in a clothes shop. She spends her time looking after the changing room where she checks customers into the changing rooms and takes the garments which are not going to be purchased from them when the customers have tried them on. There are several other shop employees, one works at the cash till, one puts out the clothes on the rails and does the shop displays, one person works in the stock room and there is a manager who does all the ordering and administration for the shop. The shop can be very quiet on some days and very busy on others. Sita does not care if customers find the right clothes – she gets paid whether they buy the clothes or not.
- Tim works in a clothing factory. He cuts out the collars for shirts. The rest of the processes for making shirts are carried out by other employees. He has done this job for two years now and gets very fed up with what he is doing. He does not worry too much if the collars are slightly uneven as he thinks customers will not notice. The other employees who work with him in the shirt department feel the same as he does.

These three employees are not happy in their work. Suggest how you would try to improve their job satisfaction. Explain the reasons for your suggestions. (You may suggest more than one way for each of the employees.) Which do you think would be the best one to use and why?

International business in focus: low levels of job satisfaction amongst Malaysian nurses



A recent study reported that shortages of nurses in Malaysia are resulting in a heavy workload and job stress, which have also been linked to low job satisfaction. Rewards for the job include wages, benefits and bonuses and personal rewards include status, recognition, personal and professional development opportunities. Reasons for nurse dissatisfaction include lack of involvement in decision-making, a poor relationship with management, low salaries and poor benefits, lack of job security and poor recognition. Job dissatisfaction is shown when nurses say they wish to leave their job.

Discussion points

- Why are the nurses unhappy?
- What could managers do to improve motivation?
- Which methods to improve motivation would be most effective for nurses and why?

Exam-style questions – Paper 1

- 1 Joe owns a business which produces wooden furniture. He employs 20 workers in the Operations department and three workers in the offices. Joe pays all his workers by time rate but he is thinking of changing to piece rate. He has a high labour turnover from the factory as his workers are not well motivated.
- a) What is meant by 'piece rate'? [2]
 - b) Identify **two** examples of fringe benefits Joe could give to his employees. [2]
 - c) Identify and explain **two** reasons why employees might leave their job at the furniture company. [4]
 - d) Identify and explain **two** ways Joe can improve the job satisfaction of his employees. [6]
 - e) Do you think piece rate is a suitable method of payment for all Joe's employees? Justify your answer. [6]
- 2 Sasha is a hotel manager. She has 30 employees working for her in the following departments: kitchen; restaurant; hotel reception; housekeeping (rooms). Sasha wants to increase the motivation of the employees and is thinking of introducing a bonus. She thinks it will make the hotel more profitable.
- a) What is meant by 'a bonus'? [2]
 - b) Identify **two** reasons why people work. [2]
 - c) Identify and explain **two** levels in Maslow's hierarchy of needs experienced by the hotel workers. [4]
 - d) Identify and explain **two** benefits to Sasha of having well-motivated employees. [6]
 - e) Do you think increasing the wage rate is the best way to increase the motivation of the employees at the hotel? Justify your answer. [6]
-

Revision checklist

In this chapter you have learned:

- about why people work and the importance of well-motivated employees
- about the different motivation theories
- about financial and non-financial rewards
- to identify when motivational methods would be appropriate to use
- to select different methods to increase job satisfaction for particular types of work.

NOW – test your understanding with the revision questions on the CD-ROM.

This chapter will explain:

- organisational charts
- simple hierarchical structures
- the role of management
- the main leadership styles
- the benefits of membership of a trade union.

Definitions to learn

Organisational structure refers to the levels of management and division of responsibilities within an organisation.

What is organisational structure?

Organisational structure refers to the levels of management and division of responsibilities within an organisation. This structure is often presented in the form of an organisational chart.

Case study example

The **Cosy Corner Convenience Store** is owned and managed by Bill Murray. It is a sole trader business. Bill has no employees. He works a long day – 12 hours usually. As he works alone in the business he has to do all the jobs which are involved in running a busy convenience store. Here is a list of just six of his tasks:

- ordering new stock
- serving customers
- going to the bank to pay in cash – he does this on Wednesday afternoons when the shop is closed
- arranging shelf displays
- keeping all the paperwork up to date, for example to make sure suppliers are paid on time
- contacting the local newspaper to arrange an advertisement for the shop.

Activity 7.1

Read the case study above. List three other tasks that you think Bill has to do in order to run **Cosy Corner** efficiently.

In Bill's business there is no need for an organisational structure because he works alone. There is no need to lay out the responsibilities and duties of other employees or to indicate their links with other workers – because there aren't any! As he is the only manager, there can be no other management levels. This example shows the simplest form of business. What would happen to the organisation of Bill's business if it expanded?

Why does organisational structure change as a business expands?

Case study example

Bill was exhausted. It was the end of another long day. He had decided during the day that he could no longer do all of the work of running the store by himself. He was going to advertise for a shop assistant. He thought carefully about what work he would want the assistant to perform. Bill remembered from his previous job, working for a large retail chain, that it was important to make clear the tasks and responsibilities of employees. If this was not done then two people might end up doing the same work – and some work might not get done at all.

He decided to write out a job description (see below) which he would give to all the people who applied for the job. This would make clear what the job would involve. Bill thought this would have two main advantages.

- People applying for the job could see if they were suitable for the work expected of them.
- Once in the job, the new employee would know exactly what their duties and responsibilities were. Their work should therefore help Bill, not just repeat what he was doing.

Bill wrote out the following job description.

Job description

Shop Assistant

Main tasks:

- To open the shop in the morning
- To be responsible for ordering all goods from suppliers
- To arrange all shelf displays
- To help serve customers
- To assist the manager in other ways directed by him

Working conditions:

- Five days a week
- Eight hours a day
- Four weeks' holiday – by negotiation, but not at same time as the manager

Activity 7.2

Read the case study above.

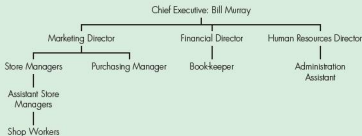
- Study the job description. Do you think Bill is looking to recruit an experienced shop assistant? What evidence is there to support your answer?
- Make a list of the important tasks and responsibilities Bill still has to perform himself.

Bill's business now has a very simple organisational structure. There are now two people in the organisation and they are specialising in different jobs.

Organisation charts

Case study example

Bill Murray's business had expanded rapidly. More employees had been appointed. Some of them managed the shop because Bill spent more time on office work. Shop opening hours were lengthened. Eventually, Bill decided to open four further stores in other towns. It became clear to Bill that his business needed the advantages of limited company status (see Chapter 4). A business friend agreed to buy shares and become one of the directors of the company. As the organisation was growing, Bill decided it needed a clear structure. After discussions with his directors and senior managers, he drew out the chart below.



In fact, this is a typical organisation chart for many businesses. The most important features are as follows.

- It is a hierarchy. This means that there are different levels in the organisation. Each level has a different degree of authority. People on the same level of hierarchy have the same degree of authority. There are five levels of hierarchy from Chief Executive down to Shop Worker.
- It is organised into departments. Each of these departments has a particular job or function.
- As there are different levels of management, there is a **chain of command**. This is how power and authority are passed down from the top to the lower levels in the organisation. Because Cosy Corner Ltd is still quite a small business, the chain of command is quite short as there are not many levels of management. Bigger businesses are likely to have many more levels of hierarchy and therefore a longer chain of command.

Bill decided to give a copy of this chart to all members of staff. He considered that there were several advantages in both constructing the organisation chart as a hierarchy and informing everybody of it.

Definitions to learn

Chain of command is the structure in an organisation which allows instructions to be passed down from senior management to lower levels of management.

Advantages of an organisation chart

- The chart shows how everybody is linked together in the organisation. All employees are aware of which communication channel is used to reach them with messages and instructions.
- Every individual can see their own position in the organisation. They can identify who they are accountable to and who they have authority over. Employees can see who they should take orders from.
- It shows the links and relationship between different departments within the organisation.
- Everyone is in a department and this gives them a sense of belonging.

Chain of command and span of control

Look at the two organisation charts below. There are two essential differences between them.

- Business A has a tall structure and a long chain of command.
- Business B has a wide structure and a short chain of command.

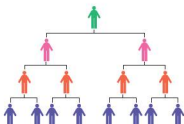
Definitions to learn

The **span of control** is the number of subordinates working directly under a manager.

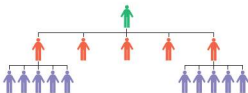
As a result of these two different structures, the **span of control** (the number of subordinates working directly under a manager) is wider in Business B than in Business A – in Business A this number is two and in Business B it is five.

There is therefore an important link between the span of control and the chain of command. The longer the chain of command, the ‘taller’ will be the organisational structure and the ‘narrower’ the span of control.

When the chain of command is short, the organisation will have ‘wider’ spans of control.



Business A – organisation chart



Business B – organisation chart

There is no perfect organisational structure. In recent years many organisations have made their structure ‘wider’ and with a shorter chain of command. In some cases, this has been done by removing a whole level of management – called de-layering. The claimed advantages of short chains of command are listed below.

Advantages of short chains of command

- Communication is quicker and more accurate. Each message has fewer levels to pass through before reaching the intended person.
- Top managers are less remote from the lower level of the hierarchy. These top managers should be more in touch with people below them as there are fewer management levels to get to know.
- Spans of control will be wider. This means that each manager is responsible for more subordinates. Why is this an advantage?

Tips for success

Make sure you can choose a suitable organisation chart for a particular business.

- If superiors have more people to manage, it will encourage managers to delegate more. This is because, as their department is larger, they cannot possibly do all the important work by themselves.
- There will be less direct control of each worker and they will feel more trusted. They will be able to take more decisions by themselves. They may obtain more job satisfaction.

However, wider spans of control, with more people to be directly responsible for, could mean that the managers lose control of what their subordinates are doing. If they are poorly trained, the subordinates could make many mistakes.

Case study example

Mustafa was bored with his work. He was a telephone operator in a large telephone banking firm. The business received calls from customers who wanted to use banking services but did not have time to go to a bank branch.

Mustafa worked in a team, called Team A, with other colleagues, Hammed and Asif. They were supervised by Aziz who was under the authority of Mohammed. There were two other groups of telephone operators, Team B and Team C. These two teams were the same size as Team A. They also had their own supervisors who reported to Mohammed.

All calls were recorded and supervisors could listen in to make sure that all workers were polite and helpful to customers. Telephone operators were only allowed to do certain tasks for customers. Other jobs, such as transfers of large sums of money, had to be referred to a supervisor or manager. Telephone operators had to aim to answer 20 calls each hour. No wonder Mustafa was bored with his work!

Activity 7.3

Read the case study above.

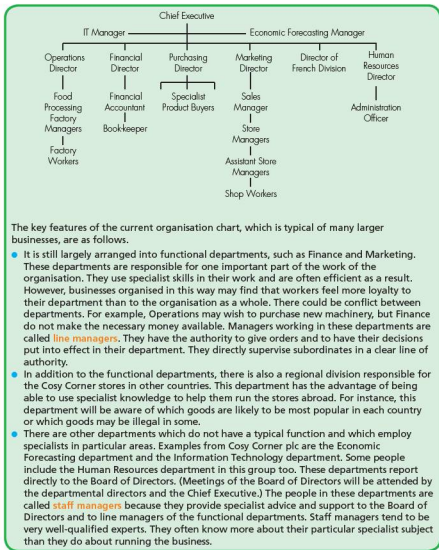
- Draw the organisation chart for this telephone business.
- What is the span of control of the supervisors?
- What would be the advantages and disadvantages of removing the supervisors altogether? Your answer should include references to:
 - chain of command
 - delegation
 - span of control.

Roles, responsibilities and inter-relationships between people in organisations

Case study example

The newly opened branches of Cosy Corner plc proved to be just as popular as the first one. Profits increased and the business expanded in other ways. Bill and his fellow directors decided to open the first store in a foreign country, France. They had plans to open several more. The directors had also taken the step of opening a food processing factory to provide some of the goods sold by the Cosy Corner stores. It was found to be cheaper to produce these goods than to buy them from outside suppliers.

These expansion projects had required a great deal of capital. The business had 'gone public' several months ago. The sales of shares to the public raised the necessary finance. Bill was Chairman of the company as well as Chief Executive. He and his Board of Directors were accountable to the shareholders. The management structure below him was now more complicated than when the business was smaller. The current organisation chart is shown below.



Definitions to learn

Line managers have direct responsibility over people below them in the hierarchy of an organisation.

Staff managers are specialists who provide support, information and assistance to line managers.

Activity 7.4

Read the case study above.

- What are the advantages and disadvantages of this tall organisation structure for *Cosy Corner plc*?
- Give three examples of conflicts which may arise from this structure.
- Do you think this organisation structure increases motivation for its employees?
- What are the benefits of having a regional division for the business?

The role of management

All organisations, including businesses, have managers. They may not be called managers because different titles can be used – leader, director, headteacher, and so on. Whatever their title, the tasks of all managers are very similar, no matter what the organisation. If you are a student in a school or college or if you are in full employment, the managers of your organisation will, at some time, have to fulfil the following functions.

Planning

Planning for the future of the organisation involves setting aims or targets, for example: ‘the school will aim to increase its sixth form to over 200 students in two years’ time’ or ‘we should plan to increase sales of our new fruit juice range by 50 per cent in three years’.

These aims or targets will give the organisation a sense of direction or purpose. There will be a common feeling in the organisation of having something to work towards. It is a poor manager who does not plan for the future at all.

In addition to these aims, a manager must also plan for the resources which will be needed. For example: ‘to achieve our aim of increasing student numbers in the sixth form, we will need to build a new sixth form centre’ or ‘increased advertising expenditure will be needed to increase sales of our fruit juices’. These are two examples of strategies which are designed to help the organisation achieve the aims set for it.

Organising

A manager cannot do everything. Tasks must be delegated to others in the organisation. These people must have the resources to be able to do these tasks successfully. It is therefore the manager’s responsibility to organise people and resources effectively.

An organisational chart can help to show who has the authority to do different jobs. It also helps to make sure that specialisation occurs and two people do not end up doing the same task. An effective manager will organise people and resources very carefully indeed.

Coordinating

Coordinating means ‘bringing together’. A manager may be very good at planning and organising but may have failed to ‘bring people in the organisation together’. This is a real danger with the functional form of organisation. Different departments can be working away in their own specialist area without making contact with people from other departments. For example, there is no point in the Marketing department planning the launch of a new product unless they have worked with (coordinated with) the Operations department. It is the Operations department that will have to produce the product at the right time in the right quantities.

A good manager will therefore make sure that all departments in the organisation work together to achieve the plans originally set by the manager. In the example above, this could be done by regular meetings between people in the different departments. Alternatively, a project team could have been set up to develop and launch the new product. The team would be made up of people from different departments.

Commanding

Many people think that this is all managers do! In fact, the task of management is more concerned with guiding, leading and supervising people than just telling them what to do – although this may be important too. Managers have to make sure that

all supervisors and workers are keeping to targets and deadlines. Instructions and guidance must be provided by managers and it is also their responsibility to make sure that the tasks are carried out by people below them in the organisation.

Controlling

This is a never-ending task of management. Managers must try to measure and evaluate the work of all individuals and groups to make sure that they are on target. There is little point in planning and organising if managers then fail to check that the original aims are being met. If it seems that certain groups are failing to do what is expected of them, then managers may have to take some corrective action. This is not necessarily disciplining staff – although that might be important. There might be other reasons for poor performance other than inefficient workers – it is the manager's job to find out why targets are not being met and then to correct the problem.

Do you now have a clearer idea of what managers do? Management is not easy to define, but the list of tasks above helps to demonstrate the varied and important work that good managers should be doing.

From studying the list of points on pages 83–84, it should also become clear why management is necessary to any organisation. Without clear and effective management, a business is going to lack:

- a sense of control and direction
- coordination between departments, leading to wastage of effort
- control of employees
- organisation of resources, leading to low output and sales.

In short, without management to take the business forward, the firm will drift and eventually fail.

Activity 7.5

Naomi is a student at a Sixth Form College. She recently took part in a work shadowing exercise to find out what it is like to be a manager. Work shadowing means that a student follows a manager for a day or more to experience the work that they do.

Naomi 'shadowed' Sabrina Choolun, who is the manager of the sportswear section in Suresave plc, a large department store. Naomi kept the following diary for one day.

- 08 30 Attended meeting with other departmental heads and Chief Executive to agree targets for the next two years. Departmental heads told to plan their own strategy to meet these goals.
- 09 15 Two staff members failed to turn up for work. Sabrina asked other staff to cover these absences by working longer shifts today.
- 10 00 Meeting with Sales Manager from big sports manufacturer. Sabrina discussed the range of goods she may purchase next year to meet the store's targets.
- 11 00 New member of staff did not cope well with awkward customer. When customer had gone, Sabrina reminded the shop assistant of the correct procedure that should be followed. Asked worker always to follow company policy in these matters.
- 14 30 Computer printouts of individual staff sales figures were studied. One worker in particular has failed to meet sales targets and it was agreed with him that further product training was necessary.
- 16 00 Email received from Sabrina's line manager. There was a problem with another department selling clothing including sports clothes. It was now possible for customers to find the same goods in the store in two departments at different prices! Sabrina needed to meet the other departmental manager to agree on a common policy.

For each of the tasks that Sabrina carried out, identify whether it was concerned with: planning, organising, coordinating, commanding or controlling.

Definitions to learn

Delegation means giving a subordinate the authority to perform particular tasks.

Delegation

Even though Bill's business is still very small it is possible to see that a very important idea is already being used. This idea is called **delegation**. This means giving a subordinate the authority to perform particular tasks. It is very important to remember that it is the authority to perform a task which is being delegated – not the final responsibility. If the job is done badly by the subordinate then it is the manager who has to accept the responsibility for this.

Advantages of delegation for the manager

- Managers cannot do every job themselves. As we have seen, it was becoming very difficult for Bill to control all of the running of Cosy Corner by himself.
- Managers are less likely to make mistakes if some of the tasks are being performed by their subordinates.
- Managers can measure the success of their staff more easily. They can see how well they have done in performing the tasks delegated to them.

Advantages of delegation for the subordinate

- The work becomes more interesting and rewarding.
- The employee feels more important and believes that trust is being put in them to perform a job well.
- Delegation helps to train workers and they can then make progress in the organisation. It gives them career opportunities.

Why might a manager not delegate?

Despite the advantages of delegation, there are some managers who are reluctant to delegate. Some may be afraid that the subordinates might fail and the manager wants to control everything by themselves. Also, there is a risk that the subordinates might do a better job than the manager! This could make the manager feel very insecure.



There needs to be an increase in trust in order to reduce control over workers

Revision summary: delegation



Different styles of leadership often call for different management styles. The way in which a manager deals with a situation can have a very important impact on people and how they react to the manager. It is important to remember here that a good manager will adopt the style of leadership that best suits each situation.

Revision summary: effective managers



Why is it important to have good managers?

- To motivate employees.
- To give guidance and advice to employees they manage.
- To inspire employees they manage to achieve more than they thought possible.
- To keep costs under control.
- To increase profitability of the business.

Leadership

Studies on motivation have emphasised the importance of good management in business and the need for leadership. There are many leaders in society – from politicians, religious leaders, captains of sports teams, to leaders of large businesses. Many people take on the role of being a leader and some are more effective than others. A good leader in a large business is someone who can inspire and get the best out of the workforce, getting them to work towards a common goal.

Styles of leadership

There are different approaches to leadership that are adopted and these can be summarised into three main **leadership styles**:

- autocratic leadership
- democratic leadership
- *laissez-faire* leadership.

Definitions to learn

Leadership styles are the different approaches to dealing with people when in a position of authority – autocratic, *laissez-faire* or democratic.

Definitions to learn

Autocratic leadership is where the manager expects to be in charge of the business and to have their orders followed.

Democratic leadership gets other employees involved in the decision-making process.

Laissez-faire leadership makes the broad objectives of the business known to employees, but then they are left to make their own decisions and organise their own work.

Tips for success

Make sure you know the leadership styles and you can apply them to different work situations.

Autocratic leadership

Autocratic leadership is where the manager expects to be in charge of the business and to have their orders followed. They keep themselves separate from the rest of the employees. They make virtually all the decisions and keep information to themselves. They tell employees only what they need to know. Communication in the business is mainly one way, that is, downward or top-down, and the workers have little or no opportunity to comment on anything.

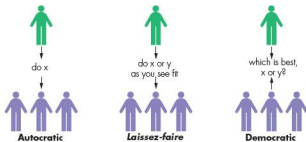
Democratic leadership

Democratic leadership will get other employees involved in the decision-making process. Information about future plans will be openly discussed before the final decision will be made, often by the leader. Communication will be both downward or top-down and upward or bottom-up.

Laissez-faire leadership

Laissez-faire is French for 'leave to do'. **Laissez-faire leadership** tends to make the broad objectives of the business known to employees, but then they are left to make their own decisions and organise their own work. Communication can be difficult in this type of organisation as clear direction will not be given. The leader has only a very limited role to play.

The style of leadership used by a manager can vary depending on the employees being dealt with and the problem to be solved. Managers may not be autocratic leaders all of the time – it may be appropriate for them to be democratic over some issues, whereas other issues will need a decision imposing on the workforce.



Leadership styles

Activity 7.6

When *Cosy Corner* convenience store started it was small and Bill Murray, the sole owner, knew all the employees by name. He used a management style which involved asking the workers what they thought about his decisions and encouraged them to tell him their ideas about the business. The business has now grown into a large public limited company with many more employees.

Look back at the case study on pages 81–82 and consider the different leadership styles which might be suitable for Bill or his managers to use.

Which do you think will be the best leadership style for Bill and his managers to use? Explain your answer.

Trade unions

Definitions to learn

A **trade union** is a group of workers who have joined together to ensure their interests are protected.

Employees generally share many of the same interests, such as improving their pay, having a pleasant environment in which to work, being treated fairly by their employer, being given proper training and working in a safe environment. Forming a trade union is a way of helping employees to achieve improvements in these different aspects of their employment – a **trade union** is a type of pressure group.

Today, trade unions are found in many different countries around the world from the US to Papua New Guinea.

Why do workers join a trade union?

When a person starts work they may be asked by someone who represents a trade union if they want to join. If the worker decides to join the trade union, they will pay an annual subscription (a yearly fee).

So what benefits does the employee receive in exchange for paying their subscription? It varies from union to union, but generally includes many of the following benefits:

- strength in numbers
- improved conditions of employment, for example, rates of pay, holidays and hours of work
- improved environment where people work, for example, health and safety, noise, heating
- improved benefits for members who are not working because they are sick, retired or have been made redundant (retrenchment)
- improved job satisfaction by encouraging training
- advice and/or financial support if a member thinks that they have been unfairly dismissed or made redundant (retrenchment), have received unfair treatment, or have been asked to do something that is not part of their job
- benefits that have been negotiated or provided for union members such as discounts in certain shops, provision of sporting facilities or clubs
- employment where there is a **closed shop**.

However, there are disadvantages to an employee of trade union membership:

- costs money to be a member
- may be required to take industrial action even if they don't agree.

Trade unions also seek to:

- put forward their views to the media and influence government decisions, for example on minimum wage legislation and employment laws
- improve communications between workers and management.

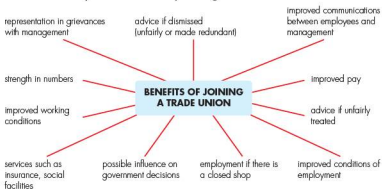
Definitions to learn

Closed shop – all employees must be a member of the same trade union.

Tips for success

Make sure you can explain the advantages and disadvantages of trade union membership from both the employees' and the employers' viewpoints.

Revision summary: benefits of joining a trade union



Activity 7.7

Shona has just started work as an Administrative Assistant in a government department and has been asked if she wants to join the trade union that represents the workers in that department. She does not know what to do as she knows nothing about trade unions. Write her a letter outlining the advantages and disadvantages of joining a trade union. Include a recommendation to Shona as to whether to join the trade union or not.

International business in focus



Chelsea Football Club has just appointed a new manager. The club had not been winning many games and the owner decided to sack the manager and employ a new one. The original manager did not tell the players what to do, he would ask them for their opinions on the game and which players the captain thought should play in the next games.

'I am a professional footballer and I know what I am talking about', said one of the players.

The owner thinks it is time for a new approach to managing and leading the players.

Discussion points

- What type of leadership style did the original manager use?
- Why does the owner want a new manager with a new leadership style?
- How might the players react to the new manager?

Exam-style questions – Paper 1

- 1 Sasha owns a business which produces office furniture. She employs 100 workers in the Operations department and 15 workers in the offices. Sasha believes in a democratic leadership style. Sasha says that being a good manager is very important to the success of the business. She sees no need for any of her workers to join a trade union.
- What is meant by a 'democratic leadership style'? [2]
 - Identify **two** examples of other leadership styles Sasha could use. [2]
 - Identify and explain **two** roles/tasks Sasha undertakes as the manager of this business. [4]
 - Identify and explain **two** reasons why having good managers is important to this business. [6]
 - Do you think Sasha is right to say that her workers do not need to join a trade union? Justify your answer. [6]
- 2 The following organisation chart is for PPB Ltd. It is a private limited company which runs a chain of supermarkets. The organisation chart shows the hierarchical structure of the business.



- What is meant by the 'hierarchical structure of the business'? [2]
- Identify how many people are in the span of control for:
 - Operations director, and
 - Finance director. [2]
- Identify and explain the role of any **two** of the functional departments, listed above. [4]
- Identify and explain **two** disadvantages to this business of having a tall organisational structure. [6]
- Do you think more delegation would be a good idea for this business? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- to draw, interpret and understand simple organisational charts
- what is meant by hierarchical structures, span of control, chain of command and delegation
- about the roles, responsibilities and inter-relationships between people in organisations
- the role of management
- that there are different styles of leadership that management might use
- why employees join trade unions.

NOW – test your understanding with the revision questions on the CD-ROM.

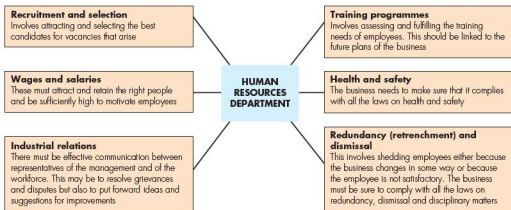
Recruitment, selection and training of workers

This chapter will explain:

- the role of the Human Resources department
- each stage of the recruitment and selection process
- benefits/limitations of part-time and full-time workers
- importance of training and different types of training
- why reducing the size of the workforce might be necessary
- recommend and justify which workers to recruit/make redundant
- legal controls over employment issues.

The work of the Human Resources department

Recruitment and selection are the most familiar roles of the Human Resources department, and this chapter will look at these roles in detail, and at another important area of human resources work – the training of employees. Redundancy and dismissal are also the responsibility of the Human Resources department and these are discussed too.



The responsibilities of the Human Resources department

Definitions to learn

Recruitment is the process from identifying that the business needs to employ someone up to the point at which applications have arrived at the business.

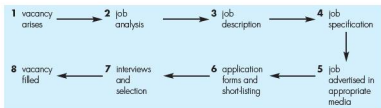
Recruitment and selection

When an employee leaves a job, when a new business is starting up or when a business is successful and wants to expand, the process of recruitment and selection starts. The business will first of all have to decide if the employee leaving a job needs to be replaced. The recruitment process also gives the business an opportunity to reassess the nature of people's jobs and consider future requirements.

In a large business this process of recruiting and selecting staff is usually undertaken by the Human Resources department. Small businesses do not recruit enough people to make it worthwhile having a separate Human Resources department – often the managers who will be supervising the employee will deal with recruitment for their department. For example, in a hotel a restaurant manager might recruit the waiters and waitresses.

The more important the job is to the business (the more technical and senior the position), the more careful and time-consuming the recruitment and selection process will be.

The recruitment process is summarised in the diagram below.



The recruitment process

Job analysis and description

The first stage of the recruitment process is to carry out a **job analysis** to study the tasks and activities to be carried out by the new employee. If the business is recruiting an employee to fill an existing post, for example if someone has left or been dismissed, an outline of the duties for the new employee will be relatively easy to draw up, and may even already exist. If the new employee is needed due to the business expanding or because the business has identified skills that it needs but no one in the business has these skills, more thought will have to go into the analysis of the job.

Once all of these details about the job have been gathered, a **job description** will be produced. A job description has several functions.

- It is given to the candidates for the job so they know exactly what the job entails.
- It will allow a **job specification** to be drawn up, to see if the candidates ‘match up to the job’, so that people with the right skills will be employed.
- Once someone has been employed, it will show whether they are carrying out the job effectively. If any disputes occur about what the employee is asked to do, it is something both the employee and the employer can refer to in order to settle any questions.

The exact content of a job description varies from business to business, but generally it will contain the following headings as outlined in the following case study.

Definitions to learn

A **job analysis** identifies and records the responsibilities and tasks relating to a job.

A **job description** outlines the responsibilities and duties to be carried out by someone employed to do a specific job.

A **job specification** is a document which outlines the requirements, qualifications, expertise, physical characteristics, etc. for a specified job.

Case study example

Here is a job description for a housekeeper in a hotel.

| | |
|-------------------------|---------------------------|
| Job title: | Housekeeper |
| Department: | Housekeeping |
| Responsible to: | Hotel Manager |
| Responsible for: | Cleaners, room attendants |

Main purpose of the job:

- Responsible for domestic services in the hotel, with an aim of keeping accommodation clean and maintained for the hotel guests.
- Responsible for the cleaners and room attendants. To take a supervisory role.

Main duties:

- allocation of duties, such as cleaning
- advising staff when queries arise
- sending soiled linen to the laundry
- organising repairs and replacement of worn items from rooms
- checking that belongings have not been left in rooms
- checking that the rooms are ready to receive guests
- informing reception when rooms are ready for occupancy.

Occasional duties:

- appointment of new staff
- training new staff in their duties
- training new staff to use the equipment
- disciplining staff as and when required
- dismissing staff if necessary.

Tips for success

Make sure you know the difference between a job description and a job specification and what they are used for.

Job descriptions sometimes also contain information about:

- the conditions of employment – salary, hours of work, pension scheme and staff welfare
- training that will be offered
- opportunities for promotion.

Job specification

Once a job description has been drawn up, the qualifications and qualities necessary to undertake the job can be specified. This list of desirable and essential requirements for the job is called a job, or person, specification. The listed requirements will usually include:

- the level of educational qualifications
- the amount of experience and type of experience
- special skills, knowledge or particular aptitude
- personal characteristics, such as type of personality.

Case study example

Here is a job specification for a housekeeper in a hotel.

| | |
|--|--------------|
| Job title: | Housekeeper |
| Department: | Housekeeping |
| <p>Details of job:</p> <ul style="list-style-type: none"> Responsible for domestic services in the hotel, with an aim to keeping accommodation clean and maintained for the hotel guests. Responsible for cleaners and room attendants. To take a supervisory role. <p>Qualifications: Essential: 4 IGCSEs (A–C) including Maths and English.</p> <p>Experience: Desirable: Minimum 1 year's experience of working in hotels.</p> <p>Skills:</p> <ul style="list-style-type: none"> Communicates effectively with people. Ability to manage people. <p>Physical fitness:</p> <ul style="list-style-type: none"> Fit, needs to be on feet all day. <p>Personal characteristics:</p> <ul style="list-style-type: none"> Honest and responsible. Friendly, helpful, organised. | |

Activity 8.1

- a) Draw up a job description for one of the following:
- Accountant
 - Shop Assistant
 - Hotel Manager
 - Teacher
- Research information to help you by asking someone who does the job or from careers information.
- b) Now draw up a job specification for your chosen job. The same research should help you to complete this task. Show which are essential and which are desirable requirements for the job.
- c) How does a job description and a job specification help to ensure the most suitable person for the job is recruited?

Definitions to learn

Internal recruitment is when a vacancy is filled by someone who is an existing employee of the business.

Advertising the vacancy

The next stage is to decide how the post will be filled.

Internal recruitment

The post could be filled from inside the organisation – **internal recruitment**. The vacancy may be advertised on a company noticeboard or, if the business is large, in a company newspaper. This would be suitable for an employee who seeks promotion within the business.

Advantages of internal recruitment

- It saves time and money, compared with recruiting someone from outside the business (advertising, interviewing, etc.).
- The person is already known to the business and their reliability, ability and potential are known.

- The person also knows the organisation's way of working and what is expected from employees.
- It can be very motivating for other employees to see their fellow workers being promoted – it makes them work harder.

Definitions to learn

External recruitment is when a vacancy is filled by someone who is not an existing employee and will be new to the business.

Tips for success

You should be able to give examples of jobs which could be advertised using each of the different methods.

Disadvantages of internal recruitment

- No new ideas or experience come into the business. Other companies may have different ways of working and these ways may be better in some respects, including making the business more efficient. Internal recruitment does not allow for these working practices to be spread.
- There may be jealousy and rivalry amongst existing employees.

External recruitment

Most vacancies are filled by **external recruitment**. This involves advertising the vacancy. There are several places the advertisement can be placed.

- **Local newspapers.** These will usually be for clerical (office) or manual (factory) positions. These types of jobs do not require a high level of skill and therefore it is likely that many people locally could fill these vacancies.
- **National newspapers.** These will usually be used for more senior positions where there may be few, if any, local people who have the right experience, skills and qualifications to do the job. The national newspapers will be read by many people who live in different parts of the country or sometimes by people who live in different countries. As the positions are senior, they will be highly paid and these people will be willing to move to another part of the country. Job vacancies in other countries are also sometimes advertised in national newspapers.
- **Specialist magazines and journals.** These will usually be used for particular technical people such as scientists. These people will read the specialist magazines and see the advertisements. Again these can be for jobs in their home country or abroad.
- **Recruitment agencies.** These are specialists in recruiting employees. They will advertise and interview people for particular types of jobs. They keep details of qualified people on their 'books'. When a suitable vacancy arises, they will put forward candidates to be interviewed for the job. Agencies are also approached by companies who need to employ a particular type of skilled worker. The agency will send along those people they think will be suitable. This method is often used when temporary contracts need filling and where the vacancy is in another country.
The use of recruitment agencies has increased in recent years. Some businesses are happy to leave the recruitment process to someone else because they have a wide range of candidates on their register. However, the services of an agency are expensive – they charge a fee for recommending the applicant which is based on a percentage of the person's salary, if the person is successfully appointed to the job.
- **Centres run by the government (Job Centres).** These are places where job vacancies can be advertised. Details of vacancies are given to interested people. The vacancies are usually for unskilled and semi-skilled jobs.

Activity 8.2

On a large sheet of paper, copy out the table below and then fill in the gaps.

Advantages and disadvantages of the different methods of recruitment

| Method of recruitment | Advantages | Disadvantages | Examples of jobs suitable for this method of recruitment |
|---|------------|---------------|--|
| Internal: | | | |
| Noticeboard at the company (or company newspaper) | | | |
| External: | | | |
| Local newspapers | | | |
| National newspapers | | | |
| Specialist magazines | | | |
| Recruitment agencies | | | |
| Government-run Job Centres | | | |

Job advertisement

After the business has decided to advertise externally, the next step is to draw up the advertisement. When drawing up a job advertisement, the business will need to decide:

- what should be included in the advert
- where the advertisement should be placed
- how much the advertising will cost and is it too expensive? (Can they afford it?)

Answering the first question is straightforward – information about the job has to be included. This will usually be the duties involved, qualifications required, salary, conditions of employment, and information about the method of application (whether it is by letter of application and CV or should they request and fill in an application form from the business).

Answers to the other two questions will depend on the vacancy being filled and whether it is a senior position or one which does not require any qualifications.

Case study example

Night Cashier for busy petrol station, 38 hours per week, Wed to Sat, 22.00–07.30, \$9.50 per hour. Start immediately. Tel. 1122 44551

Industrial Engineering Professional

Multi-site role throughout the country: based in New City. Competitive rate of pay with fringe benefits. Qualityfoam Ltd is a leading manufacturer of polyurethane foam operating in 16 countries and a major supplier to the home country's furniture industry.

Appealing to results-orientated professional, responsibilities will include performance improvement, business analysis, project management and capital expenditure appraisal.

You will be a graduate of calibre, numerate and PC literate, with at least three years' experience in manufacturing.

Please write with full CV to: Mr M. Ahmed, MD, Qualityfoam Ltd, New Road, New City, 3412 8769.

Administration Assistant required \$15.00 per hour

Good all-round administration skills needed to undertake a variety of duties within the organisation. Knowledge of WORD or similar package essential. Immediate start.

Please write or telephone for an application form from:

Mr S. Singh, ZYT Ltd, 2341 Old Road, New City, 456723. Tel. 0892 557739

Activity 8.3

Read the case study on the previous page.

- Which advert would have appeared in a national newspaper and which would have been in the local newspaper? Explain your choice.
- Design your own advertisement for the job for which you drew up a job description and job specification (page 95). Where would you place this advertisement, and why?
- Compare your advert with that of the other students in your group. Which would be most likely to attract the best people to apply for the job and why?

Application forms and CVs/résumés

A job advertisement will require the applicant to apply in writing. This can either be by requesting, and then filling in, an application form, or by writing a letter of application and enclosing a curriculum vitae (CV) or résumé. A CV or résumé is a summary of a person's qualifications, experience and qualities, and is written in a standard format.

A business will use the application forms, or letters and CVs, to see which of the applicants match the job specification. The applicants who are the closest match are the ones who will be invited for an interview – the selection stage. A shortlist will be drawn up.

A curriculum vitae (CV) or résumé must be well laid out and clear. It should usually contain the following details:

- name
- address
- telephone number
- date of birth
- nationality
- education and qualifications
- work experience
- positions of responsibility
- interests
- names and addresses of referees (for references).

The letter of application should outline briefly:

- why the applicant wants the job
- why the applicant feels he/she would be suitable.

Application forms are sometimes completed in place of the CV and usually ask for the same information. They may sometimes ask for other information that is specifically relevant to the job.

Activity 8.4

- a) Study this job advertisement and the information from three application forms below. Which of the three people would be most suitable for the job? Give reasons for your choice of the successful applicant and why you would reject the other two applicants.

Personal Assistant (PA)

Salary in excess of \$20 000 per year

The General Manager at our New City office requires an experienced and highly skilled Personal Assistant to provide a complete support service. In a typically busy day you will manage the General Manager's office, word process a variety of documents, maintain an accurate diary and liaise with customers, clients and corporate contacts.

You will need to be able to demonstrate excellent keyboard skills, knowledge of Microsoft Office and associated programs, a good standard of numeracy and literacy and have previous experience in a similar role.

If you enjoy working with a friendly team, please send your CV to Corinne Ogunbanjo, Human Resources, NYDB plc, 3286 New Street, New City, 467813.

| | Applicant 1 | Applicant 2 | Applicant 3 |
|-----------------------------------|---|---|--|
| Name | Caroline Sharma | Pablo Gitano | Sara Gherman |
| Address | 2144 Main Road, New City | 4245 Long Row, New City | 9876 New Road, New City |
| Age | 19 | 29 | 38 |
| Educational qualifications | 5 IGCSEs, including English, Maths and Computer Studies. Administration qualifications – Level 1 | 6 IGCSEs, including English, Maths and Computer Studies. Administration qualifications – Levels 1 & 2 | 5 O-levels, including English and Maths. Administration qualifications – Levels 1, 2 and 3 |
| Previous employment | 6 months as a junior administration assistant | 1 year as office junior 3 years on reception 6 years as personal assistant | Switchboard duties – 2 years Reception – 3 years General office duties – 6 years Head of Administration section – 6 years Personal Assistant – 2 years |
| Interests/hobbies | Playing sports – member of several local teams, going to see friends, voluntary helper with a youth group | Reading, member of local football team, playing piano, rock climbing | Reading, going to the cinema, watching television |

- b) What additional questions do you think should have been on the application form? Why should they have been asked?
- c) Design your own application form for the job for which you produced an advertisement on page 98.

Interviews

The applicants who are shortlisted and invited for interview will have provided the names and addresses of referees. These are people who will be asked to provide a reference (give their opinion on the applicant's character, honesty, reliability and their suitability for the job). References are usually confidential, which means the applicant does not see what has been written about them. This should allow the person giving the reference to be honest in their opinions. Sometimes an 'open' reference or testimonial will be given. These are not confidential, indeed the applicant may bring these along themselves.

If the applicant is a school leaver, it is normal to give their school as a referee. If the applicant is older, usually a former employer will be used.

Interviews are still the most widely used form of selection. However, interviews are not always the most reliable way of choosing the best person for the job. The main purposes of an interview are to assess, in the shortest possible time:

- the applicant's ability to do the job
- any personal qualities that are an advantage or disadvantage
- the general character and personality of the applicant – will they fit in?

Interviews can be one-to-one, two-to-one or a panel of people to interview the applicant. Panel interviews are usually used for more senior positions.

Some businesses include tests in their selection process, for example:

- *Skills tests* aim to show the ability of the candidate to carry out certain tasks.
- *Aptitude tests* aim to show the candidate's potential to gain additional skills. Either general intelligence tests or more specific tests are used to assess the candidate's ability to train for a particular job.
- *Personality tests* are used if a particular type of person is required for the job, if the job requires the ability to work under stress or if the person will need to fit in as part of a team of people.
- *Group situation tests* give tasks to applicants to complete in group situations and the group is observed. Each applicant will be assessed on the way they work as a member of the team and the way they tackle the tasks themselves. Again, a job that requires the applicant to work as part of a team, for example on projects, will often use this type of selection procedure during the selection process.

Tips for success

Make sure you can explain why particular interview questions might be asked. Don't just repeat a question if you are asked to explain why an interview question is being asked.

Tips for success

Make sure you can explain how the information from these tests might be helpful in choosing between applicants.

Activity 8.5

Imagine that you are now going to interview candidates for the vacancy that you advertised in Activity 8.3. You have drawn up the following six questions to ask the interviewees.

- 1 What is it about the job that attracted you to apply for it?
 - 2 What do you know about the company?
 - 3 Tell me more about your hobbies and interests.
 - 4 Why do you feel you are particularly suitable for the job?
 - 5 Where do you see yourself in five years' time?
 - 6 Do you have any questions?
- a) What is the purpose of each of these questions? What are you hoping to find out?
b) What other questions ought to be asked?
c) Get other students in your class to apply for the job you have advertised and then carry out a mock interview. Would you offer them the job?

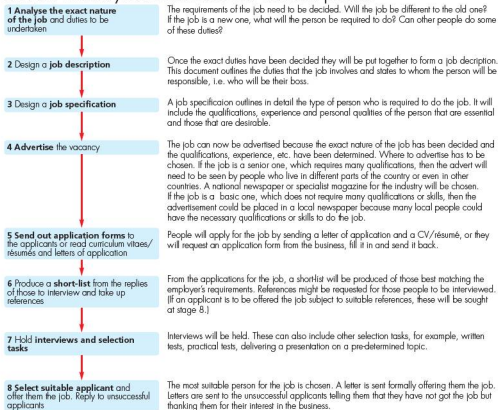
Rejecting unsuccessful applicants

When the suitable applicant has been offered the job and has accepted it, the unsuccessful applicants should be informed that they have not got the job and thanked for applying.

Activity 8.6

- An international construction company has just won a contract to build a dam in an African country. How might the Human Resources department recruit the following workers for the contract:
 - experienced engineers
 - labourers?
- An international airline is expanding its operations in Latin America. It needs to recruit staff to be based in just this continent, as the flights will not go all around the world. What recruitment and selection methods would it use to appoint:
 - airline pilots
 - cabin crew (air stewardesses and stewards)?

Revision summary: the recruitment and selection process



The contract of employment

In many countries in the world it is a legal requirement for employers to provide a new employee with a contract of employment to sign. It will set out the terms of the relationship between the employee and the employer. It will usually be set out in writing and include the following:

- name of employer and name of the employee
- job title
- date when employment is to begin
- hours to be worked
- rate of pay and any other benefits such as bonus, sick pay, pension
- when payment will be made
- holiday entitlement
- amount of notice to be given to terminate the employment that the employer or the employee must give to end the employment.

Part-time and full-time (contracts of employment)

A **part-time** worker is someone who works fewer hours than a **full-time** worker.

There is no specific number of hours that makes someone full- or part-time, but a full-time worker will usually work 35 hours or more a week. The number of hours which workers usually work in a week will vary from one country to another. The contract of employment will give a different number of hours to show whether it is a part-time or full-time job. Employers can benefit from employing workers on a part-time contract rather than a full-time contract.

The advantages to the business of employing part-time workers are:

- more flexible in the hours of work
- easier to ask employees just to work at busy times
- easier to extend business opening/operating hours by working evenings or at weekends
- fits in with looking after children and therefore employee is willing to accept lower pay
- less expensive than employing/paying a full-time worker.

The disadvantages to the employer are:

- less likely to be trained because the workers see the job as temporary or the employers think the employees will leave or won't want promotion
- takes longer to recruit two part-time workers than one full-time worker
- can be less committed to the business/more likely to leave to get another job
- less likely to be promoted because they will not have gained the skills and experience as full-time employees
- more difficult to communicate with part-time workers when they are not in work.

The advantages and disadvantages of full-time workers is the opposite to part-time workers (that is, the advantages of part-time workers are the disadvantages of full-time workers).

Definitions to learn

Part-time employment is often considered to be between 1 and 30–35 hours a week.

Full-time employees will usually work 35 hours or more a week.

Training

There should be clear objectives for training employees. Training is important to a business as it may be used to:

- introduce a new process or new equipment
- improve the efficiency of the workforce
- provide training for the unskilled workers to make them more valuable to the company
- decrease the supervision needed
- improve the opportunity for internal promotion
- decrease the chances of accidents.

Employees should be clear about the benefits of the training or they will not work hard or take the training seriously.

Training covers many different needs. Some may be short term, such as one-day courses on how to operate a new machine safely. Others may last a few days and some may be long term where a programme of management training is involved, such as an MBA (Masters degree in Business Administration).

Training is usually trying to achieve one or more of the following:

- increase skills
- increase knowledge
- change people's attitudes/raise awareness, for example, customer service.

There are three main types of training:

- **induction training**
- **on-the-job training**
- **off-the-job training.**

Induction training

This is carried out when an employee is new to the post. When a new employee starts at a company, they will not know where anything is or who people are or what is expected of them. The induction programme will last sometimes for a day, sometimes for several days – it depends on the company and the particular job. When a person starts a new school, they are shown round, introduced to teachers and told about their lessons – this is the same type of information you would need to know if you had just joined a new company.

The advantages of induction training are that it:

- helps new employees to settle into their job quickly
- may be a legal requirement to give Health and Safety training at the start of a job
- means workers are less likely to make mistakes.

The disadvantages of induction training are that it:

- is time consuming
- means wages are paid but no work is being done by the worker
- delays the start of the employee commencing their job.

Definitions to learn

Induction training is an introduction given to a new employee, explaining the firm's activities, customs and procedures and introducing them to their fellow workers.

On-the-job training occurs by watching a more experienced worker doing the job.

Off-the-job training involves being trained away from the workplace, usually by specialist trainers.

Case study example

The following is an induction programme for a shop assistant.

| | |
|-------|---|
| 08 30 | Introduction |
| 08 45 | Company history |
| 09 00 | Company structure |
| 09 30 | Administration details: <ul style="list-style-type: none">● Company regulations● Health and safety in the workplace● Uniform |
| 10 30 | Break |
| 10 45 | Workplace: <ul style="list-style-type: none">● Map of the premises – places of work● Staffroom● Staff canteen● First aid point● Fire exits● Human Resources Manager's office |
| 11 45 | Conditions of employment: <ul style="list-style-type: none">● Rate of pay● Hours worked● Sickness and holiday pay● Pensions● Disciplinary procedures● Breaks● Staff purchase/discounts |
| 12 45 | Training opportunities |
| 13 00 | Lunch |
| 13 30 | Job training: <ul style="list-style-type: none">● Customer service● Stacking shelves/presentation of shelves● Pricing goods● Using bar code reader● Using tills● How to deal with difficult customers● Security |
| 17 00 | Close |

On-the-job training

This is where a person is trained by watching a more experienced worker doing the job. They are shown what to do. This method of training is only suitable for unskilled and semi-skilled jobs.

The advantages of on-the-job training are that:

- individual tuition is given and it is in the workplace so the employee does not need to be sent away (travel costs are expensive)
- it ensures there is some production from the worker whilst they are training
- it usually costs less than off-the-job training
- it is training to the specific needs of the business.



The disadvantages of on-the-job training are that:

- the trainer will not be as productive as usual because they are showing the trainee what to do instead of getting on with their job
- the trainer may have bad habits and they may pass these on to the trainee
- it may not necessarily be recognised training qualifications outside the business.

Off-the-job training



This is where the worker goes away from the place where they work. This may be in a different part of the building or it may be at a different place altogether, such as a college or specialist training centre. The techniques used to train workers are more varied and can involve more complex tasks. Off-the-job training often involves classroom learning, using lecture, role play, case studies or computer simulations. This may be similar to how you are taught.

The advantages of off-the-job training are that:

- a broad range of skills can be taught using these techniques
- if these courses are taught in the evening after work, they are cheaper for the business because the employee will still carry out their normal duties during the day
- the business will only need to pay for the course and it will not also lose the output of the employee
- employees may be taught a variety of skills, they become multi-skilled and this makes them more versatile – they can be moved around the company when the need arises
- it often uses expert trainers who have up-to-date knowledge of business practices.

The disadvantages of off-the-job training are that:

- costs are high
- it means wages are paid but no work is being done by the worker
- the additional qualifications means it is easier for the employee to leave and find another job.

Training is necessary for the success of most businesses. It is a form of investment, but in human capital not physical capital. Investment usually leads to greater output in the future and this is true of employees as well as machinery.

Tips for success

Make sure you can explain and give examples of when on-the-job and off-the-job training is suitable for particular jobs.

Activity 8.7

Copy out the table below and fill in the gaps.

Advantages and disadvantages of methods of training

| Method of training | Description | Advantages | Disadvantages |
|----------------------|-------------|------------|---------------|
| Induction training | | | |
| On-the-job training | | | |
| Off-the-job training | | | |

Revision summary: training (management)



Revision summary: training (employee)



Activity 8.8

For each of the examples below, decide what type of training would be most appropriate and why.

- S&S plc have just introduced a new computer program into the accounts offices. All the accounts employees will need to know how to use the new software.
- Sandeep has been given a job as a trainee manager with a large retail company. The training will last for about two years.
- James has just got a job as a hotel porter. He has never done this type of job before. He is starting work next week.

Situations in which downsizing of workforce is necessary

Definitions to learn

Workforce planning is establishing the workforce needed by the business for the foreseeable future in terms of the number and skills of employees required.

Workforce planning is where the business will need to decide on the type and number of employees needed in the future. The number required will depend upon the firm's sales forecasts, its future plans such as expansion or automation, and its objectives, for example, introducing new types of products. Often businesses will require additional employees when they are expanding but sometimes they will need to downsize the workforce (reduce the number of employees). This can be because of:

- introduction of automation
- falling demand for their goods or services
- factory/shop/office closure
- relocating their factory abroad
- a business has merged or been taken over and some jobs have become surplus to requirements in the newly combined business.

When it has been decided how many employees will be required and what their skills need to be, the Human Resources department can plan how this will be achieved by:

- finding out the skills of all the present employees
- counting out anyone who will be leaving soon, for example, due to retirement
- consulting with existing staff as to who could and would want to retrain to fill the new jobs
- preparing a recruitment plan to show how many new staff will be needed and how they should be recruited (internally or externally).

If a business needs to reduce the number of employees this can be done in one of two ways:

- dismissal
- redundancy.

Workers may also leave their job because they:

- retire (they are getting older and want to stop working)
- resign (because they have found another job).

Definitions to learn

Redundancy is when an employee is no longer needed and so loses their job. It is not due to any aspect of their work being unsatisfactory.

Dismissal

This is where a worker is told to leave their job because their work or behaviour is unsatisfactory. For example, an employee who was constantly late for work and who, despite being given warnings, continued to be late, would probably be dismissed. An employee who was caught stealing or who was unable to do the job to a satisfactory standard would be dismissed. In some countries, an employee can take the business to

Tips for success

Make sure you can explain the difference between redundancy and dismissal.

court if they feel they were unfairly dismissed. Therefore a business needs to make sure they have followed all the laws in their country when dealing with their employees.

Redundancy

There may be occasions when a number of employees will no longer be needed, through no fault of their own – for example during a period of falling sales resulting from an economic recession.

When an employee is made redundant, they may be given some money to compensate them for losing their job. In some countries this is laid down in law, for example, one week's wages for every year that the employee has worked for the business. The following factors help a business to decide which workers to make redundant and which to retain.

- Some workers may volunteer – because they may have another job they can go to, they want to retire early or want to start their own business.
- Length of time employed by the business – workers who have worked for the business for a long time are often retained. They will have the most experience and be the most expensive to make redundant, if redundancy payments are made.
- Workers with essential skills that are needed by the business or whose skills could be transferable to other departments are often retained.
- Employment history of the worker – whether they have a good/poor attendance, punctuality or appraisal record.
- Which departments of the business need to lose workers and which need to retain workers.

Legal controls over employment issues

In the UK, and several other countries, governments have passed laws that affect equal employment opportunities. The effects of these laws are that people should be treated equally in the workplace and when being recruited, and that they should be paid equal amounts for similar work.

This means that if a man and a woman are both equally well-qualified for a job they should be treated equally. It should not be the case that one rather than the other is given the job simply because of their sex.

This is also true of people who have a disability, people from different races and people of different religions.

What does this mean for businesses?

- It means they have to be careful when wording an advertisement for a job – for example, they cannot advertise for a woman – they must say 'person'.
- When selecting an employee for a job they must treat all applicants equally. If a business does not do this, then they would be prosecuted and fined.
- By following these laws carefully, businesses should recruit and promote staff on merit alone and this should help to increase motivation at work.

What laws are there in your country which might affect equal opportunities?

Employees are workers in a business. This section also covers the legal rights of those who wish to become employees and who apply for jobs.

Employees need protection in the following areas:

- against unfair discrimination at work and when applying for jobs
- health and safety at work
- against unfair dismissal
- wage protection.

Protection against unfair discrimination

Discrimination means to make a choice. The discrimination we are concerned with here is when it is based on unfair reasons. For example, some employers discriminate unfairly against workers or people applying for jobs because they:

- are of a different race or colour
- belong to a different religion
- are of the opposite sex
- are considered too old/young for the job
- are disabled in some way.

In most countries many of these forms of discrimination are illegal. If they were not illegal, many sections of society would find it very difficult to gain jobs or to achieve promotion at work. Businesses can also lose out by practising unfair discrimination. They could fail to select a very good worker just because they used one of the reasons above not to select the person.

In addition to these laws, many employers have an equal opportunities policy. Employees who consider that they have been unfairly discriminated against can appeal to an equal opportunities committee.

Health and safety at work

Many years ago, most employers cared little for the safety of their workers. Machines did not have safety cages. Protective clothing was not issued. Conditions were often very hot or cold, noisy and unpleasant. The arguments often used by employers to explain such conditions were that: it would cost too much to make workplaces safe; if the existing workers did not like the conditions, then they could leave as there were many unemployed people who would do their work!

In our modern world such attitudes are no longer acceptable. Most employers now care for their workers' safety. One reason for this is that many laws have been passed that have forced them to improve health and safety at work. In most countries there are now laws which make sure that all employers:

- protect workers from dangerous machinery
- provide safety equipment and clothing
- maintain reasonable workplace temperatures
- provide hygienic conditions and washing facilities
- do not insist on excessively long shifts and provide breaks in the work timetable.

Are health and safety laws and controls over business a good idea? Most managers think so. Workers cost a great deal to recruit and train. It is worthwhile keeping them safe and healthy. Such workers are likely to be better motivated, work more efficiently and stay with the firm for a longer period of time.

For these reasons, some employers in countries where there are weak health and safety laws will still provide working conditions of a very high safety standard. The managers of these firms have taken an **ethical decision**. That means that they have a set of standards or a set of moral rules that prevent them from acting in an unfair or dangerous way towards their workers. Do these managers make better employers? Most workers would think so, and would be better motivated to work harder and stay with the business because of this.

Unfortunately, in some countries there are employers who still take advantage of workers. There may be no protection on the length of shifts and many millions of children can still be seen working in industries that offer little protection from danger

Definitions to learn

Ethical decision – a decision taken by a manager or a company because of the moral code observed by the firm.

and ill health. In these countries workers are exploited and often paid low wages. Business costs are therefore very low. Should the rest of the world continue to buy products from these countries? What is your view?

Protection against unfair dismissal

Once in work, employees need protection from being dismissed unfairly. Obviously if the worker has stolen from the employer or is always late for work, dismissal would be reasonable. The following examples of dismissal are unfair:

- for joining a trade union
- for being pregnant
- when no warnings are given before dismissal.

In the UK, if a worker feels that they have been dismissed unfairly, then they can take their case to an **industrial tribunal**. This will hear both sides of the argument and may give the worker compensation if it believes that dismissal was unfair. Industrial tribunals are similar to courts of law and they can also be used to hear disputes between workers and employers on sex and race discrimination and redundancy.

Wage protection

Workers have a right to be paid for work they do for employers. There should be a written agreement between worker and employer – the **contract of employment** – which will contain details not only of the hours of work and the nature of the job but also of:

- the wage rate to be paid
- how frequently wages will be paid
- what deductions will be made from wages, for example, income tax.

In some countries employers can pay whatever wage rate they like. If there is high unemployment or if unemployment benefits are low, workers may be offered very low wages. Workers could find it very difficult to live on these wages. Increasingly, governments are taking action against employers who pay low wages. This action often takes the form of a legal minimum wage. A minimum wage exists in parts of China, India and in the US. A minimum wage makes it illegal for an employer to pay an hourly rate below the minimum set. A legal minimum wage has a number of claimed advantages and disadvantages.

Advantages of a legal minimum wage

- It should prevent strong employers from exploiting unskilled workers who could not easily find other work.
- As many unskilled workers will be receiving higher wages, it might encourage employers to train them to make sure that they are more productive.
- It will encourage more people to seek work. There should be fewer shortages of workers.
- Low-paid workers will earn more and will be able to afford to spend more.

Disadvantages of a legal minimum wage

- It increases business costs which will force them to increase prices.
- Some employers will not be able to afford these wage rates. They may make workers redundant instead. Unemployment may rise.
- Other workers receiving just above the minimum level may ask for higher wages to keep the same differential between themselves and lower paid workers. Business costs will again increase.

Definitions to learn

An **industrial tribunal** is a legal meeting which considers workers' complaints of unfair dismissal or discrimination at work.

A **contract of employment** is a legal agreement between employer and employee listing the rights and responsibilities of workers.

Tips for success

Make sure you can explain why governments introduce laws to protect employees. Also make sure you can explain how these laws affect both employers and employees.

Activity 8.9

Consider the way in which Gowri Kumaran was treated by her employer.

She applied for a job as machine operator in a radio assembly factory. The employer offered her the job and said that her contract of employment would be sent to her after one month's trial. After one month, Gowri received her wages but was surprised to see that her wage rate was much less than expected. She was also earning much less than other workers doing the same work. There had been several deductions from her wages which she did not understand. She did not receive a contract of employment as had been promised.

Gowri had complained to her supervisor that there were some loose electrical wires on her machine but no action had been taken. She worked 10-hour shifts with only one break. Gowri decided to join a trade union but when the manager heard about this he called her into his office. He told her that her work was unsatisfactory and she was no longer required. Gowri was very upset about the way she had been treated. She asked for your advice, as her legal adviser, on what she should do.

- Do you think that Gowri has been badly treated by her employer? Give reasons for your answer.
- As Gowri's legal adviser, write a letter to the manager of the factory where she used to work. Explain to the manager all of the points of law which you think the manager has broken.
- What might be the advantages to employers from treating their staff well?

International business in focus: Kenya Airways

Kenya Airways has sent 40 newly recruited cabin crew for training in Egypt. It was said that, 'The institute in Cairo is one of the cheapest but offers high quality training.' The training was needed as part of an expansion programme at Kenya Airways. The expansion is in long-haul routes into Asia and training new bilingual staff is required in addition to increased numbers of cabin crew. The airline looked abroad, as their domestic training facilities are overstretched. The recruitment and selection process used by Kenya Airways for its cabin crew is very extensive. 'We are determined to offer the best standards of in-flight service' said the Operations Director.

Discussion points

- Why is high-quality training important to Kenya Airways?
- Why do you think that Kenya Airways did not use on-the-job training for the cabin crew?
- Suggest ways in which Kenya Airways could recruit and select appropriate workers as cabin crew.

Exam-style questions – Paper 1

- 1 Sarah owns a business which manufactures musical instruments. There has been an increase in sales and profits over the last two years but there has been a fall in demand for some products. She employs 50 skilled production workers. She wants to recruit five more factory workers to make pianos but needs fewer workers to make violins. She intends to carry out a job analysis for the factory workers who make pianos. Sarah uses on-the-job training for new workers joining the business.
- a) What is meant by 'job analysis'? [2]
 - b) Identify **two** examples of suitable places Sarah could advertise the vacancies. [2]
 - c) Identify **two** questions which Sarah could ask the job applicants at interview. Explain why each question is asked. [4]
 - d) Identify and explain **two** advantages of on-the-job training for this business. [6]
 - e) Sarah needs fewer skilled workers to make violins. What do you think Sarah should do? Justify your answer. [6]
- 2 Mr Patel owns an insurance company. He advises clients and finds insurance policies for customers and a fee is paid for his services. He employs ten well-qualified workers. His business needs to recruit an extra five well-qualified workers and will need to draw up a job description and job specification. Mr Patel intends to use external recruitment to recruit these workers.
- a) What is meant by a 'job description'? [2]
 - b) Identify **two** examples of requirements he might put in a job specification. [2]
 - c) Identify and explain **two** reasons why Mr Patel wants to recruit well-qualified workers. [4]
 - d) Identify and explain **two** items Mr Patel might put in an induction programme. [6]
 - e) Do you think external recruitment is better than internal recruitment for Mr Patel? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- the role of the Human Resources department
- each stage of the recruitment and selection process
- how to draw up a job description
- how to draw up a job specification
- how to choose suitable ways of advertising a vacancy – either internally or externally
- how to draw up a CV and an application form
- how to draw up questions for interviews
- benefits/limitations of part-time and full-time workers
- the importance of training and different types of training, including how to design an induction programme
- the difference between on-the-job and off-the-job training
- how to analyse and evaluate the relevance of training to both the management and the employee
- why reducing the size of the workforce might be necessary
- which workers to recruit/make redundant
- why governments pass laws to protect employees.

NOW – test your understanding with the revision questions on the CD-ROM.



Internal and external communication

This chapter will explain:

- the importance of effective communication to business
- the difference between internal and external, formal and informal communication
- the different methods of communication
- the barriers to effective communication and how they can be overcome.

What is effective communication and why is it necessary?

Definitions to learn

Communication is the transferring of a **message** from the sender to the receiver, who understands the message.

The **message** is the information or instructions being passed by the sender to the receiver.

Internal communication is between members of the same organisation.

Communication occurs when a **message** is transferred from one person to another, who understands the content of the message.

We all communicate with other people every day of our lives. We communicate with our families, at school or college, when we go shopping, or when chatting with friends. Communication with others is a natural part of life. Why do we need to study something which comes naturally to us? There is one important reason for this and that is: communication must be effective. This means that the information or message being sent is received, understood and acted upon in the way intended. If it isn't, it can be annoying for us when we communicate with our friends. For businesses, communication which is not effective, or communication failure, can have serious consequences.

Internal communication

Why do people within a business need to communicate with each other?

In all organisations, it is necessary for people to communicate with each other in various ways. Without communication, we would all be working as individuals with no links with anybody else in the business we worked in. The tasks of management in guiding, instructing, warning and encouraging workers would become impossible.

Here are some examples of common messages communicated within businesses (**internal communication**). The way in which each message is given is also shown.

- 'Please do not smoke in this area.' (notice on a table)
- 'How many hours did you work last week?' (manager asks a worker)
- 'There will be a Fire Drill at 11 00 today.' (notice on a board)
- 'The cutting machine has broken down. Can you send the engineer as soon as possible?' (telephone call)
- 'Sales last week reached a record level. You will need to increase output so that we do not run out of inventories.' (emailed memorandum to Operation Manager)
- 'Keep this door locked at all times.' (sign on a door)
- 'You have been sacked because of frequent absences from work. Please acknowledge receipt of this letter.' (letter written to an employee)

- ‘Shoplifting is on the increase in our store – this meeting gives all employees a chance to suggest ideas on how the problem can be reduced.’ (meeting with all shop workers in a store)

Tips for success

When answering a question about communication remember to state whether you are referring to internal or external communication.

The list could have been very long indeed, but these examples show the wide range of topics which need to be communicated in business. Can you imagine the serious problems that could occur if these messages were not communicated effectively to the people who need the information they contain?

Activity 9.1

- Suggest three more examples of internal communication within a business or your school or college.
- Give details of the message to be sent and the method you think should be used to send it.
- Justify why you have chosen these communication methods.

Definitions to learn

External communication is between the organisation and other organisations or individuals.

External communication

This occurs when messages are sent between one organisation and another or between the organisation and individuals other than employees, for example customers. Some of the main examples of **external communication** are:

- orders for goods from suppliers
- sending information to customers about prices and delivery times
- advertising goods or services (this is covered in detail in Chapter 14)
- asking customers to pay bills on time.

One type of communication is not more important than another. It is just as important for a business to have good external communication as good internal communication. The key features of both types are the same. The methods of communication which can be used are also similar although the growth of social networking has transformed how a business can communicate with the ‘outside world’. The main difference between internal and external communication is who is being communicated with.

Why external communication has to work well

External communication is very important to the image and efficiency of a business. If a firm communicates ineffectively with suppliers, it may be sent the wrong materials. If it sends inaccurate information to customers, they may buy a product from another firm.

Here are some more examples of external communication. You can imagine how serious it would be if communication was not effective in all of these cases.

- A Finance Manager writes a letter to the tax office asking how much tax must be paid this year.
- A Sales Manager records a customer order taken over the internet for 330 items to be delivered by next Wednesday.
- A business must contact thousands of customers who have bought a product which turns out to be dangerous. An email is sent to all customers who bought the product to ask them to return the item for a refund.

Definitions to learn

The **transmitter** or **sender** of the message is the person starting off the process by sending the message.

The **medium of communication** is the method used to send a message, for example, a letter is a method of written communication and a meeting is a method of verbal communication.

The **receiver** is the person who receives the message.

Feedback is the reply from the receiver which shows whether the message has arrived, been understood and, if necessary, acted upon.

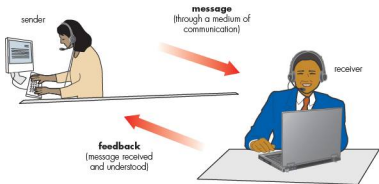
Activity 9.2

- Suggest three more examples of external communication from a business or your school or college.
- Give details of the message to be sent and the method you think should be used to send it.
- Justify why you have chosen these communication methods.

The process of effective communication

Effective communication involves the following four features:

- a **transmitter** or **sender** of the message – this is the person who wishes to pass on the information to others. This person has to choose the next two features carefully in order to make sure that communication occurs effectively
- a **medium of communication** or a method for sending the message, for example, a letter or noticeboard
- a **receiver** of the information – the person to whom the message should be sent
- **feedback**, where the receiver confirms that the message has been received and responds to it. This ensures that the information has been correctly received by the right person and, if necessary, acted upon.



The features of effective communication

Activity 9.3: Communicating with workers

Sales were below target at the Co-operative Retail Store. The manager was very concerned about this. She decided to write to every worker, about 30 in all, to warn them of the problem of falling sales and how jobs were now at risk. In the letter she asked for ideas on how to increase sales. Workers were asked to confirm that they had received the letter and tell her if they had any good ideas.

- In this case study, identify:
 - the sender of the message
 - the medium being used
 - the receiver of the message.
- Did the communication involve feedback?
- Do you think that the method used by the manager to communicate with workers was the best one to use? If not, which method would have been more effective? Explain your answer.

Definitions to learn

One-way communication involves a message which does not call for or require a response.

Two-way communication is when the receiver gives a response to the message and there is a discussion about it.

One-way and two-way communication

One-way communication occurs when the receiver of a message has no chance to reply or respond to the message. An example would be an instruction to 'take these goods to the customer'. One-way communication does not allow the receiver to contribute to communication or to provide any feedback.

Two-way communication is when there is a reply or a response from the receiver. This could be just simple confirmation of receipt of the message or it could be a discussion about the message. Both people are therefore involved in the communication process. This could lead to better and clearer information.

Activity 9.4

Refer to the list of messages on pages 113–14. The method used to send or transmit each message is also given. Which messages are most likely to lead to:

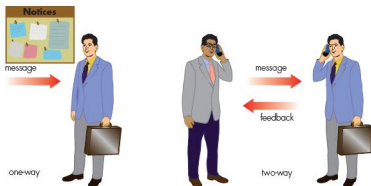
- two-way communication?
- one-way communication?

Give reasons for your answer in each case.

The advantages of two-way communication

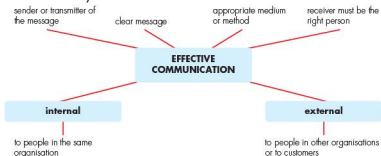
When the receiver has to, or decides to, give feedback to the sender of the message there are two main benefits.

- It should become absolutely clear to the sender whether or not the person receiving the message has understood it and acted upon it. If they have not, then perhaps the message needs to be sent again or made clearer. Effective communication has not taken place until the message is understood by the receiver.
- Both people are now involved in the communication process. The receiver feels more a part of this process. He or she can make a real contribution to the topic being discussed or communicated. This may help to motivate the receiver.



The difference between one-way and two-way communication

Revision summary: effective communication



Communication methods

Information can be sent or transmitted in a number of different ways – these are called the communication media.

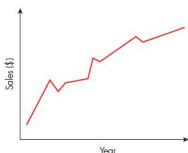
- Verbal methods of communication involve the sender of the message speaking to the receiver.



- Written methods of communication include letters and notices/posters but increasingly involve the use of information technology (IT).



- Visual methods of communication include methods such as diagrams, charts and videos.



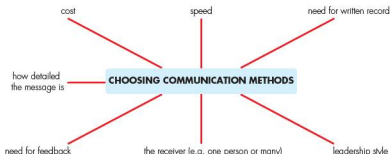
Which is the best way to communicate a message? There is no simple answer to this question. Sometimes it is better to use verbal communication and on other occasions it is essential to use written communication. Different messages require different methods of communication, so there is no best method in all cases.

Choosing the appropriate communication method

There are several factors that the sender of a message should consider before choosing the most appropriate method to use to communicate with the receiver:

- **Speed** – is it important that the receiver gets the information really quickly? For example, a manager from a foreign division of a company must be told about a cancelled meeting before he catches his flight.
- **Cost** – is it important to keep costs down or is it more important to communicate effectively, regardless of cost? For example, customers need to be informed about a serious safety problem with a product.
- **Message details** – how detailed is the message? If it contains technical plans, figures and illustrations then, clearly, written and other visual forms of communication are likely to be essential.
- **Leadership style** – is the leadership style a democratic one? If it is, then two-way verbal forms of communication with employees are much more likely to be used than they would be by an 'autocratic leader'.
- **The receiver** – who is/are the 'target' receiver(s)? If just one person has to be communicated with, and they work in the next office, then one-to-one conversation is likely to be used. However, this would be inappropriate if hundreds of workers needed to receive a message.
- **Importance of a written record** – if it is essential that a written record can be referred to at some time in the future, then, clearly verbal communication would be inappropriate. For example, legal contracts or receipt of new orders from customers must have written records.
- **Importance of feedback** – if it is essential that the sender receives feedback, perhaps very quickly, then a direct verbal method of communication might be most appropriate. For example, has the customer just leaving the shop paid for those goods yet?

Revision summary: how to choose communication methods



Verbal communication methods

Verbal, or oral, communication methods include:

- *one-to-one* talks/meetings between the sender and the receiver
- *telephone* conversations
- *video conferencing*, where groups of people in different locations are able to see and hear each other through a video/Internet link
- *meetings and team briefings*, which could involve few or many people.

Advantages of verbal communication

- Information can be given out quickly. When this happens at big meetings, it is an efficient way of communicating with a large number of people.
- There is opportunity for immediate feedback and two-way communication.
- The message is often reinforced by seeing the speaker. The body language of the speaker, how they stand and their facial expressions, can help to put the message across effectively. This, of course, does not apply to telephone conversations.

Disadvantages of verbal communication

- In a big meeting, there is no way of telling whether everybody is listening or has understood the message.
- It can take longer to use verbal methods when feedback occurs than to use a written form of communication.
- When an accurate and permanent record of the message is needed, such as a warning to a worker, a verbal method is inappropriate.

Written communication methods including those based on information technology

Written methods of communication include:

- *business letters* – used for either internal or external communication, they should follow a set structure
- *memos* (an abbreviation of memorandum) – written messages used only internally. Many businesses use computers to send these through the internal email system. An example of a memo sent by email is shown on the next page.

MEMORANDUM

To: Sales Manager

From: Distribution Manager

Date: 3/8/2013

Subject: Delivery of damaged goods

The problem of damaged goods reaching our Newtown branch has been solved. It was discovered that the boxes were being loaded on to the truck without any rope attaching them.

I have met with the loading supervisor to tell him that this must not happen again.

- *reports* – detailed documents about a particular issue or problem. These are often produced by experts working in the business. They can be sent to managers to read before a meeting to discuss the issue. Very often these reports are so detailed that they could not be understood by all employees
- *notices* pinned on boards – these are used to display information which is open to everyone. However, there is no certainty that they are read
- *faxes* (facsimile messages) – written messages sent to other offices by electronic means via telephone lines
- *text messages* – today, cell (mobile) phones are a major part of peoples' lives. They allow for quick and convenient communication with others. One of the most used functions on the cell phone is not the phone, but the instant text messaging – such as when organising a business meeting at short notice: just take out your cell phone, type in a quick 'meet me @ 2 plz' and press send. Text messaging is an easy and discrete way of communicating with others.

Text messaging allows the 'sender' to communicate with others in situations where a face-to-face or phone conversation is not possible or appropriate. Also, a record exists of the communication – until this is deleted. However, there is no way of assessing the tone of the message or the 'mood' of the sender and this can cause some failures in communication.

- *email* and *social networking sites* and *Tweeting* and other forms of electronic communication using information technology – these have revolutionised communications in recent years. Written messages can be sent between two or more people with computing facilities. Printouts of messages can be obtained if a 'hard copy' is required.

Intranets provide easy messaging to all workers in a business with access to a computer.

The internet allows easy and effective communication with customers and suppliers.



Mainstreet Trading @mainstreethare

19 Oct

Book of the Day: Carte Blanche by Jeffrey Deaver. Get ready for Skyfall by reading the latest Bond book, now in paperback.

@hodderbooks

Retweeted by Hodder & Stoughton

Collapse ← Reply ↻ Retweet ★ Favorite

An example of a Tweet sent via Twitter®

Advantages of written communication

- There is ‘hard’ evidence of the message which can be referred to in the future. This should help to reduce disagreements between the sender and the receiver about the contents of the message.
- It is essential for certain messages involving complicated details which might be misunderstood if, for example, a telephone call was made. Also, the law in many countries requires certain safety messages to be written and displayed in offices and factories. It is not sufficient to tell people about safety measures – they could be forgotten.
- A written message can be copied and sent to many people. This could be more efficient than telephoning all of those people to give them the same message verbally.
- Electronic communication is a quick and cheap way to reach a large number of people.

Disadvantages of written communication

- Direct feedback is not always possible, unless electronic communication is used. This can, however, lead to too many email messages being created and ‘information overload’, leading to people not being able to pick out the really important messages from the many that might be received. With written messages in other forms, two-way communication is difficult.
- It is not so easy to check that the message has been received and acted upon as with verbal messages – although this can be done with email as a ‘please acknowledge’ function can be set up.
- The language used can be difficult for some receivers to understand. If the written message is too long it may be confusing and lose the interest of the reader.
- There is no opportunity for body language to be used to reinforce the message.

Visual communication methods

Visual methods of communication include:

- *Films, videos* and *Microsoft PowerPoint* displays – often used by businesses to help train new staff or to inform sales people about new products.
- *Posters* – can be used to explain a simple but important message by means of a picture or cartoon. For example, the dangers of operating an unguarded machine or the waste of leaving lights switched on.
- *Charts and diagrams* – can be used in reports or letters to show numerical data or to simplify complicated ideas such as how the business is organised. Examples of these appear in other chapters of this book. Computers and relevant IT packages can be used to present data in a wide variety of different tables, charts, graphs and diagrams. Printouts of these can then be obtained as a hard copy to add to reports and other documents.
- *Photographs and cartoons* – these can be used to add variety, colour and humour to a message – all of which may increase the chances of the communication being read and understood by the receiver.

Advantages of visual communication

- These methods can present information in an appealing and attractive way. People are often more prepared to look at films or posters than to read letters or notices because of the interesting way they communicate messages.

Tips for success

Remember that in some cases it might be essential to use written forms of communication (for example with legal contracts). In other cases, for example when advertising a new product, communication with potential customers could be best achieved with more visual methods.

- They can be used to make a written message clearer by adding a chart or diagram to illustrate the point being made.

Disadvantages of visual communication

- There is no feedback and the sender of the message may need to use other forms of communication to check that the message is understood. For example, training videos are often followed by a written test for the new staff to check their understanding.
- Charts and graphs are difficult for some people to interpret. The overall message might be misunderstood if the receiver is unsure of how to read values from a graph or how to interpret a technical diagram.

Activity 9.5: Methods of communication

Copy out this table of communication methods. Under the headings of speed, written record and feedback, fill in the key advantages or disadvantages of each. The first one has been done for you.

| | Speed | Written record | Feedback |
|---------------------------|--|---|---|
| Letter | Slow – takes time to write letter and postal service might be poor | Yes – receiver has the letter and the sender is likely to keep a copy | Likely to be slow – the receiver may not reply at all |
| Telephone call | | | |
| Meeting with employees | | | |
| Social network site | | | |
| Staff newspaper | | | |
| Website | | | |
| Email | | | |
| Notice | | | |
| Face-to-face conversation | | | |
| Advertising poster | | | |
| Text message | | | |

Revision summary: communication methods



Activity 9.6

Which communication method might be most appropriate for the following messages? Justify your answer in each case.

- There should be no smoking in the staff canteen.
- The management want to instruct all employees on how the new computer system works.
- Details of the firm's sales figures for the last four years are being sent to shareholders.
- The Finance Manager wants to remind the Operations Manager that they have arranged a meeting for next week.
- The Product Development Manager wants to inform directors of the market research into three new product ideas. He hopes that they will agree to launch one of these products.
- The Office Manager wants to obtain views from all office workers on how paper waste could be reduced.
- A supervisor plans to warn (for the last time) a worker who is always late for work.
- Next year's holiday dates need to be made available to all workers.
- The Human Resources Manager wants to invite an applicant for a job to an interview.
- The Operations Manager wants to send the plans for a new factory to the Managing Director, who is on a foreign business trip.
- Existing customers of a bank are to be informed about a new type of bank account.
- A new contract needs to be agreed and signed between a farmer and the cooperative he sells his milk to.
- The Marketing department of a cosmetics business wants to launch a new perfume aimed at women with above average incomes.

Definitions to learn

Formal communication is when messages are sent through established channels using professional language.

Informal communication is when information is sent and received casually with the use of everyday language.

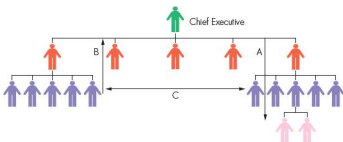
Formal and informal communication

If you are a school student or in employment, how do you receive messages which are important to you? You may read notices on the noticeboard, receive reports, emails or memos or attend official meetings. These are all examples of **formal communication**. Are they the only way you learn about what is going on in your organisation? Almost certainly not.

You are also likely to receive messages through **informal** channels, such as meetings with friends or contact with others in the canteen or at break times. These informal, or unrecognised, meetings are sometimes referred to as the 'grapevine'. Sometimes these informal channels can be used by managers to 'try out' the reaction to new ideas, such as a new shift system in the factory, before communicating details of the new system formally. If the reaction to management from the grapevine is negative, they may not introduce the new idea at all. At other times, the informal channels can spread gossip and rumour which is unhelpful to managers. Managers, however, cannot prevent the informal links existing between people in the organisation.

The direction of communications

A typical organisation chart for a business is shown below.



Look at the arrows. They indicate the direction of communication.

Tips for success

The sender of any message needs to be clear about who it is meant for.

- Arrow A shows downward communication. This is when messages are sent from managers to subordinates. It can be used for instructions or statements on important business decisions. It does not allow for feedback. If these messages have to pass through many levels of hierarchy then the original meaning of the message could become distorted (see 'Communication barriers' below).
- Arrow B shows upward communication. This is when a message or feedback is passed from subordinates to managers. As we have seen, such feedback can be an essential part of effective communication. Workers in an organisation have much to offer by being involved in the communication process. They should not be afraid of contributing to discussions or meetings. The organisation has much to gain when the managers are prepared to listen to and to act upon messages received from those lower down the organisation.
- Arrow C shows horizontal communication (sometimes referred to as lateral communication). This occurs when people at the same level of an organisation communicate with each other. Information and ideas can be exchanged at both formal and informal meetings. This can be a cause of conflict between departments; for example, if Marketing informs Operations that the quality of output is so poor that the consumers are returning goods as faulty!

Definitions to learn

Communication barriers are factors that stop effective communication of messages.

Communication barriers

As we saw on page 115, there are four parts to any successful communication – sender, receiver, medium used and feedback. Communication can fail if any one of these four parts does not operate as it should. If one part fails, it would be called a **barrier** to effective **communication**. This would cause a breakdown in communications, which could lead to serious problems for the organisation.

The most common barriers to effective communication and ways to overcome them are listed in the table on the next page.

Barriers to effective communication and how they can be overcome

| Barrier | Description | How the barrier can be overcome |
|----------------------------|--|---|
| Problems with the sender | Language which is too difficult is used. 'Jargon' or technical terms may not be understood by the receiver | The sender should ensure that the message uses language which is understandable. Use of jargon or terms which are too technical should be avoided |
| | The sender uses verbal means of communication but speaks too quickly or not clearly enough | The sender should make the message as clear as possible. Feedback should be asked for to ensure the message is being understood |
| | The sender communicates the wrong message or passes it to the wrong receiver | The sender must make sure that the right person is receiving the right message |
| | The message is too long and too much detail prevents the main points being understood. This is again the fault of the sender | The message should be as brief as possible to allow the main points to be understood |
| Problems with the medium | The message may be lost so the receiver does not see it | It is important to insist on feedback. If no feedback is received then the sender assumes the message was lost |
| | The wrong channel has been used, e.g. an important message was put on the noticeboard which most people did not read | The sender must select the appropriate channel for each message sent |
| | If the message is sent down a long chain of command, the original meaning of the message may be lost. It could become distorted | The shortest possible channel should be used to avoid this problem |
| | No feedback is received | This could be because, e.g., a letter was sent to workers asking for their opinions. A meeting would have been more useful |
| | Breakdown of the medium, e.g. computer failure or postal strike | Other forms of communication should, where possible, be made available |
| Problems with the receiver | They might not be listening or paying attention | The importance of the message should be emphasised. The receivers should be asked for feedback to ensure understanding |
| | The receiver may not like or trust the sender. They may be unwilling to act upon his or her message | There should be trust between both the sender and the receiver or effective communication is unlikely. Perhaps another sender should be used who is respected by the receiver |
| Problems with feedback | There is no feedback | Perhaps no feedback was asked for. Perhaps the method of communication used did not allow for feedback |
| | It is received too slowly or is distorted. As with the original message, perhaps the feedback is passing through too many people before being received by the original sender of the message | Direct lines of communication between subordinates and managers must be available. Direct communication is always more effective |

Tips for success

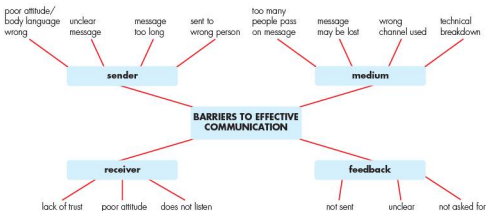
Questions about communication barriers often ask for suggestions about how communication failure can be prevented or overcome.

Activity 9.7: Reducing communication barriers

Sanchez is a successful business leader. He started his own business, STC, importing tea and coffee five years ago. He now employs 45 people – 30 in his country and 15 in countries that produce the tea and coffee. As he is very busy he holds few meetings with his workers. He emails his managers daily and expects them to pass on his instructions to the workers they are responsible for. In recent weeks, some supplies of tea and coffee have not been to the exact quality and taste that Sanchez demands and he is very angry. He wants to tell his managers and workers how they must improve. He wrote to them all several months ago for new ideas on how to improve the business but he did not get any replies!

- Identify four possible causes of communication barriers within STC.
- Explain to Sanchez how he could overcome the four communication barriers that you identified in a).

Revision summary: barriers to effective communication



International business in focus: Coca-Cola blog for worldwide employee survey

The Coca-Cola corporation is using a blog as a communication channel through which the 55 000 employees of the global company can provide their views on Coca-Cola's vision, mission and values.

Orlando Ashford, head of Human Resources (HR) at Coca-Cola's US headquarters in Atlanta, Georgia, says that Coca-Cola can be one of the most respected companies in the world only when it's clear to employees what the company stands for. This will only be achieved by effective communication.

Coca-Cola's top 150 managers met last year and decided on the seven principles which describe Coca-Cola's culture. Now it is up to Coca-Cola's workers to communicate their views.

The employee blog will be open for a week with one principle for discussion on each day – seven principles, seven days – and enables each employee anywhere in the world to participate.

This blog method employee survey is not unique. IBM has recently used a similar method. Ashford says he wants to see Coca-Cola management everywhere in the world setting an example and participating in blogging.

Discussion points

- Explain why Coca-Cola's HR head believes that effective communication with workers is important.
- Do you think that blogging is the best way to obtain the views of a large number of workers?

Exam-style questions – Paper 1

- 1 Manuel is HR Manager for a large bank. His responsibilities include internal communication with individual workers and groups of workers. Sometimes he wants to send a message to all 15 000 workers employed by the bank. Some workers complain that unless they spend time reading notices or email messages they fail to receive important information.
- What is meant by 'internal communication'? [2]
 - Identify **two** benefits of using notices as a form of communication. [2]
 - Identify and explain **two** possible barriers to communication within the bank. [4]
 - Identify and explain **two** ways in which Manuel could communicate with individual workers about their pay and working conditions. [6]
 - Do you think that electronic forms of communication are always the best ones to use when communicating with large numbers of workers? Justify your answer. [6]
- 2 SEP manufactures electrical appliances such as cookers and heaters. One of Phil's responsibilities as Marketing Manager at SEP is to communicate with thousands of customers in many countries. Some of these customers are wholesalers but many are individual consumers who have bought products directly from the business. Phil is worried that communication barriers sometimes prevent his messages being received effectively.
- What is meant by 'communication barriers'? [2]
 - Apart from customers, identify **two** external groups SEP might need to communicate with. [2]
 - Identify and explain **two** types of written communication with customers that Phil could use. [4]
 - Identify and explain **two** possible causes of communication barriers between Phil and SEP's customers. [6]
 - SEP has discovered a major safety problem with one of its products. It needs to communicate with customers quickly. Explain the advantages and disadvantages of **i**) telephoning all customers and **ii**) sending an email to them. Which method of communication is best in this case? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- why internal and external communication is important in different business situations
- how to select the best method of communication for different messages
- the most common reasons for communication failure – barriers to communication
- how businesses can overcome these barriers to communication.

NOW – test your understanding with the revision questions on the CD-ROM.

People in business: end of section case study (Paper 2 style)

The Lakeview Restaurant

The Lakeview Restaurant is owned by two brothers, Chris and Abdul. They set up the restaurant ten years ago as a private limited company. It is located on the edge of the city.



The business is split into two separate dining areas. One area is for families and the other area serves more expensive meals for business people. The family dining area is large and is hired out for weddings and birthday parties. The other area is mainly for business customers.

Both sections of the restaurant are always busy and fully booked on weekdays. Chris and Abdul want to expand the business. The restaurant cannot be expanded on its existing site as it has buildings on one side and it is next to a lake on the other side. New workers for the kitchens and waiters will need to be recruited, whichever option is chosen.

There are two options for the business to expand:

- Option 1: Buy a ship and convert it into a floating restaurant next to the main restaurant to hire out for weddings and birthday parties. The ship will cost \$100 000 to buy and convert it to a restaurant. The projected net profit is \$20 000 per year. Unemployment in the area is high.
- Option 2: Close the existing restaurant and relocate to a new building which is much larger and is in the centre of the city. The additional cost of buying a new restaurant is \$250 000 and the projected net profit is \$25 000 per year. Unemployment in the city centre is low.

Appendix 1

Two job applications for the post of manager of the Lakeview Restaurant

| Name | Mr J Patel | Mr N Guitano |
|---|--|--|
| Qualifications | 10 IGCSE, 3 A levels, BA Degree in Business Management | 7 IGCSE, 2 A levels |
| Management experience | 3 years as General Manager of a small café | 20 years as restaurant manager |
| Interests | Cricket, football, rugby, reading | Reading, watching television, helped keep the accounts for a local children's charity. |
| Personal status | Married, 4 children | Single, no children |
| Number of restaurants at which they have worked | 4 restaurants for 4 weeks each as they were holiday jobs | 10 different restaurants in 20 years |
| Preferred management style | Autocratic – believes the manager knows best | Democratic – believes employees should be asked their opinions |

Appendix 2

5th June Meeting

From: Chris (c-smith@gotmail.co.uk)

Sent: 23 October 2013 23:41:47

To: Abdul (Abdul@gotmail.com)

Cc:

Hi Abdul

We need to employ a new restaurant manager. We had to dismiss the last manager as he failed to motivate employees – we do not want someone like him again.

I want someone who is careful with money and will give a good service to the customers. They need to come up with ideas of how to increase the number of customers to the restaurant on weekends.

What do you think?

- 1 a) Identify and explain **two** reasons why well motivated employees are important for the restaurant. [8]
 - b) Chris and Abdul have advertised a job vacancy for a restaurant manager. Look at Appendix 2, compare the two job applicants and decide who you would choose to employ. Justify the reasons for your choice. [12]
 - 2 a) The Lakeview Restaurant is expanding. Identify and explain **two** reasons why an organisation chart would be helpful to the management of the restaurant. [8]
 - b) The restaurant needs to communicate with its suppliers to order its weekly food ingredients. Consider the advantages and disadvantages of using email, letter or telephone. Recommend which is the best method for Chris and Abdul to use. Justify your answer. [12]
- Optional questions**
- 3 a) The Lakeside Restaurant is located near to several restaurants which are competitors. Explain **one** advantage and **one** disadvantage to the business of being located near to competitors. [8]
 - b) Consider the advantages and disadvantages of the two options for the restaurant business to expand. Recommend which option Chris and Abdul should choose. Justify your choice. [12]

Section

3

Marketing

Chapters

- 10 Marketing, competition and the customer
- 11 Market research
- 12 The marketing mix: product
- 13 The marketing mix: price
- 14 The marketing mix: promotion and technology in marketing
- 15 The marketing mix: place
- 16 Marketing strategy



Marketing, competition and the customer

This chapter will explain:

- the role of marketing
- why markets change in terms of consumer spending patterns and competition, and how businesses respond to these changes
- the difference between mass marketing and niche marketing
- how and why market segmentation is carried out.

The Marketing department

Most businesses, unless they are very small, will have a Marketing department. In a large public limited company, the Marketing Director will have people responsible for market research of new products, promotion (including promotions and advertising), distribution, pricing and sales.



The structure of a typical Marketing department

The bigger the company, the more people will be employed in the Marketing department and the more sections there are likely to be.

- *The Sales department* is responsible for the sales of the product. It will usually have separate sections for each region to which the product is distributed. If the product is exported, there may also be an Export department.
- *The Market Research department* is responsible for finding out customers' needs, market changes and the impact of competitors' actions. It will report on these to the Marketing Director and this information will be used to help make decisions about: research and development of new products, pricing levels, sales strategies and promotion strategies.
- *The Promotion department* deals with organising the advertising for products. It arranges for advertisements to be produced. For example, adverts are filmed if they are to be on television, or designed if they are to be in newspapers. The department also decides on the types of promotion that will be included in campaigns. It will have a marketing budget – a fixed amount of money to spend. It has to decide which types of advertising media will be the most effective to use because there will only be a certain amount to spend; the department cannot spend what it likes!
- *The Distribution department* transports the products to the market.

Activity 10.1

In which department – Sales, Market Research, Promotion or Distribution – do each of the following people work?

- Anya spends most of her time in other countries showing the product to people who buy inventory for large retail groups.
- Mohamed spends his time arranging for adverts of the product to be placed in newspapers and magazines.
- Paul spends much of his time carrying out questionnaires.
- Mary organises the airline flights for the products to be sent to their markets abroad.

The role of marketing

Marketing is not just about advertising and selling a good or service, as can be seen by the different marketing activities found in a Marketing department. The central role of marketing is to:

- **identify customer needs** by finding out what kind of products or services customers want, the prices they are willing to pay, where and how they want to buy these goods or services and what after-sales services they might want
- **satisfy customer needs** in order to achieve sales of their goods or services. Customers want the right product, in the right place and at the right price. Failure to do this, or to do it less well than competitors, will lead to the failure of the business
- **maintain customer loyalty** by building customer relationships. Keeping close links with customers and finding out if products or services are continuing to meet their needs will help to ensure the success of the business. If customers change their expectations of what they want from a good or service then the business should respond to meet these new needs. This will be identified by maintaining close relationships with customers. It is very important to keep existing customers (customer loyalty) and not just concentrate on attracting new ones. It is much cheaper to try to keep existing customers (for example, with loyalty cards) than trying to gain new customers
- **gain information about customers** to meet their changing needs and to establish a long-term relationship with them. This is one of the most important roles of the Marketing department today. Building a relationship with customers means that market research information can be used to understand why customers buy products and how they use them. This makes for better and therefore more effective marketing
- **anticipate changes in customer needs** by identifying new trends in customer demand or gaps in the market so that businesses can produce goods or services which are not currently available.

If the Marketing department is successful in identifying customer requirements and predicting future customer needs, it should enable the business to meet one or more of the following objectives:

- raise customer awareness of a product or service of the business
- increase sales revenue and profitability
- increase or maintain **market share**
- maintain or improve the image of products or a business
- target a new market or market segment
- enter new markets at home or abroad
- develop new products or improve existing products.

Definitions to learn

Market share is the percentage of total market sales held by one brand or business.

Case study: Pepsi Cola



At present, Pepsi Philippines, which manufactures Pepsi, Seven-Up, Mountain Dew, Gatorade, Tropicana and Lipton, accounts for 20 per cent of the total carbonated drinks market in the Philippines. It wants to expand its operation and increase its share of the market still further. The Marketing department will be vital in deciding how this can be achieved.

Tips for success

Make sure you can choose suitable packaging for different products to ensure the correct appeal for the brand image/target market.

Activity 10.2

Read the case study above.

- Suggest ways Pepsi Philippines could increase its market share. Which way do you think will be most effective? Explain your answer.
- Do you think Pepsi Philippines should develop new varieties of drinks to sell in this market? Explain your answer.
- Identify who could be the new customers of these drinks.
- Explain what types of advertising and promotion might be effective in attracting these customers.

Understanding market changes

Sales of goods and services from particular businesses do not stay the same year after year or even month after month. Things don't stay the same forever! Some markets are changing at a rapid pace, such as mobile (cell) phones, whereas other markets, such as breakfast cereals, don't change very quickly.

Why customer/consumer spending patterns change

- **Consumer tastes and fashions change** – fashions may change for clothes and so consumers may want different styles of clothes to those they wore last year.
- **Changes in technology** – with new products being developed, such as iPads and notebooks, sales of standalone computers have fallen in many countries. New products mean old versions/alternatives do not have high sales anymore.
- **Change in incomes** – if an economy has high unemployment then many consumers will buy cheaper products. If the economy then grows and unemployment falls the sales of more expensive products will increase.
- **Ageing populations** – the age structure of the population in many countries is changing to a greater percentage of older people. This has changed the type of products which are increasing in demand, such as anti-ageing face creams for women.

The power and importance of changing customer needs

If businesses fail to respond to customer needs then they are likely to fail. Customers are 'king' because as their needs change, it is the businesses which research and know what these changes are, and respond to them, that will be the ones which are successful (see Case study Activity 10.3).

Why have some markets become more competitive?

- Globalisation of markets has meant that products are increasingly sold all over the world (see Chapter 28).
- Transportation improvements have meant that it is easier to get products from one part of the world to another part of the world.
- Internet/e-commerce has meant that consumers can search for products and buy from overseas markets. Even some services such as insurance can be bought from businesses based in another country. Increased consumer information about products and the different international businesses that produce them makes a market much more competitive.

How can businesses respond to changing spending patterns and increased competition?

A business will have to take action to maintain its market share whenever there is growth amongst its competitors. This may also be necessary if the image of the business has been harmed by bad publicity in the newspapers or on television (for example, if a particular toy doll has harmed a child). In this case the business will need to find ways to convince customers that the problem has been corrected. If it does not, then the sales revenue and profits will go down. Improving or maintaining image is an important factor in improving or maintaining market share.

In order to remain successful, a business may need to:

- **maintain good customer relationships** – this has a key role in continuing to meet customer needs and it also provides market research information about customers. Marketing departments which become experts on customer needs will respond to these needs and maintain customer loyalty. It has been shown that it is often cheaper to keep existing customers than gain new ones
- **keep improving its existing product** – this is especially true if its competitors improve their products. By making the goods it sells very different from those produced by competitors the business will become well known for differentiated products. Apple is a good example of a company that reacts to increased competition by making even more advanced products
- **bring out new products to keep customers' interest** in their company rather than their competitors. This will help them to maintain, or even increase, their market share. An example of this would be Microsoft, which keeps on improving and developing its operating systems
- **keep costs low to maintain competitiveness** – as this should help keep low prices.

Case study example

What happens when change catches up with you?

'The world is changing very fast. Big will not beat small any more. It will be the fast beating the slow.' (Rupert Murdoch).

One of the few things that is certain in this world is change. In a world where technology is advancing at such a rapid pace then change happens even more quickly. It is very important for companies to adapt to change as rapidly as they can.

Take the example of Kodak, which filed for bankruptcy in 2012 in a bid to survive a cash crisis, caused by years of falling sales of its photographic film for cameras (as digital cameras had taken over the market). Kodak, a pioneer in the photographic film business, has tried to restructure to become a seller of consumer products like cameras.

Consumers' preference for digital cameras is on the rise in India, with the market for digital cameras growing at 40 per cent in volume terms (according to industry estimates). Prices of digital cameras are falling, and with additional features that allow video recording it means camera manufacturers such as Sony, Canon and Samsung are enjoying rising sales.

Activity 10.3

Read the case study above.

- Why has Kodak got into financial difficulties? Explain your answer.
- Suggest how keeping in close contact with customers might have avoided this problem.

What is meant by a market?

A market for a particular good or service is made up of the total number of customers and potential customers as well as sellers for that particular good or service. It can be measured by the total number of sales or by the value of the sales for that good or service by all suppliers to that particular good or service. These markets can be either mass markets or niche markets.

Mass marketing

If a product has a very large number of sales it could be said to be sold to a **mass market** (many people in the population will buy this product, for example aspirin, washing powder or soap). Products are designed to appeal to the whole market and therefore advertising and promotions are intended to appeal to most customers. The advantages of selling to a mass market are:

- the sales to these markets are very large
- the firm can benefit from economies of scale (see Chapter 18)
- risks can be spread, as often the business will sell several different variations of products to the mass market, and if one variety of the product fails then the other products may still sell well
- opportunities for growth of the business due to large potential sales.

However, there are disadvantages:

- high levels of competition between firms
- high costs of advertising
- standardised products or services are produced and so may not meet the specific needs of all customers or potential customers, therefore leading to lost sales.

Definitions to learn

Mass market is where there is a very large number of sales of a product.

Definitions to learn

Niche market is a small, usually specialised, segment of a much larger market.

Tips for success

Make sure you can explain the difference between a mass market and a niche market using examples of goods or services.

Niche marketing

However, some products, often specialised products, are only sold to a very small number of customers who form a very small segment of a much larger market. This is referred to as a **niche market**. These products are quite often sold by small firms as they have too few sales for large firms to bother with. For example, there is a mass market for shops selling food products in any country. However, if there is a small group of migrant workers in that country then food shops selling specialised food for this group of people may be set up. Expensive products, such as Rolex watches or designer clothes, are aimed at a small section of much larger markets.

Being able to identify and supply a niche market has advantages.

- Small firms are able to sell to niche markets as large firms may not have identified them but concentrated on the mass markets instead. This may avoid competition from the larger businesses.
- The needs of consumers can be focused on and therefore targeted by the firm in a niche market. This will give them an advantage over larger firms who aim to meet the needs of the mass market rather than the needs of these specific customers.

However, there are disadvantages of supplying to a niche market.

- Niche markets are small and therefore have a limited number of sales, which means only small businesses can operate in these markets. If the business wants to grow it will need to look outside the niche market to find sales of other products.
- Often businesses in a niche market will specialise in just one product. This means that if the product is no longer in demand the business will fail as the business has not spread its risks. Producing several products rather than just one product means that if one fails there are other products which are still in demand and the business carries on trading.

Market segments

The market for a particular good or service is made up of the total number of customers and potential customers for that particular good or service. Market segmentation recognises that all potential users of a good or service are not all the same, and what appeals to one set of consumers may not appeal to others.

Market segmentation is when a market is broken down into sub-groups which share similar characteristics. For example, chocolates are eaten by young children, teenagers and adults of both sexes. Different brands of chocolates will appeal to these different groups of people. A Marketing department will divide the whole market into different groups and categories; these are called market segments.

Each segment is investigated in great detail. When it comes to advertising, the Marketing department know the best places to advertise and the most likely place the particular market segment will see the advertisement. They will also know how to design the advertisement to appeal to the particular market segment they are aiming at. An example might be teenagers buying clothes. They might be asked questions about which magazines they read, which television programmes they watch, which mobile (cell) phone they have and general questions about what they like. This will enable the Marketing department to select the best times to advertise, if television advertisements are to be used, and the type of adverts that will appeal to teenagers. They can advertise in magazines that are usually read by teenagers or design a new app for free download.

Definitions to learn

Market segment is an identifiable sub-group of a whole market in which consumers have similar characteristics or preferences.

Segmenting a market can help a business to:

- make marketing expenditure cost effective by producing a product which closely meets the needs of these customers and only targeting its marketing efforts on this segment
- enjoy higher sales and profits for the business, because of cost-effective marketing
- identify a market segment which is not having its needs fully met, and therefore offer opportunities to increase sales.

Some of the most common ways of how a market can be segmented are shown in the table below.

Ways of segmenting a market

Tips for success

Remember that consumers can be part of more than one segment. You should be able to explain how and why businesses segment a market and use examples to illustrate this.

| | |
|--------------------------------|---|
| By socio-economic group | Income groups can be defined by grouping people's jobs according to how much they are paid. For example, managers are usually paid more than office staff. Office staff are usually paid more than production workers. Unemployed people will obviously be the lowest income group. This often means that products are priced differently to target certain income groups. For example cars range in size, performance and price level. Only someone on a high income could afford a Ferrari, but a person on a much lower income might afford to buy a Tata Nano. Some perfumes are sold at low prices whereas other perfumes are very expensive and are aimed at different income groups. |
| By age | The products bought by people in different age groups will not be the same. Young people buy different clothes to elderly people. The toys bought for babies will vary from those bought for older children. |
| By region/location | In different regions of a country people might buy different products. For example, if there are dry and wet parts of the country then waterproof clothing would be sold in the rainy part of the country, but not in the dry part. If the product is exported, then it may need to be changed slightly (for example, a different name or different packaging) in order to appeal to the tastes of people in other countries. |
| By gender | Some products are bought only by women or only by men. For example, a shaving razor would normally be bought by a man, whereas a perfume would normally be bought by a woman. |
| By use of the product | For example, cars can be used by consumers for domestic use or for business use. The advertising media and promotions methods used will differ. Cars for business use may be advertised by sending brochures out to businesses, whereas cars for domestic use may be advertised on television. These cars may be the same models, but they will be marketed in a different way. |
| By lifestyle | For example, a single person earning the same income as a married person with three children will spend that income differently, buying different products. |

Decide the best place to advertise to increase sales

A marketing manager would take all these factors into account when deciding which segments might buy new products or improved products. Therefore, once the segments have been identified, this will influence how the products are packaged and advertised. It will also affect the choice of shops the products are sold in, in order to get maximum sales.

Potential benefits of segmentation to business

The business can use market segmentation to sell more products. They do this by making different brands of a product and then aiming each brand at a different market segment. As can be seen in the example of soap in the case study below, a business could produce various brands of soap to satisfy most of the market segments.

By finding out the different segments in a market, a business can sometimes identify a segment whose needs are not being met (there is a gap in the market). They can then produce a suitable product to meet these customer needs and again increase sales.

Case study example

This is an example of how the market for soap may be segmented.

| Type of soap | Characteristics of market segment |
|------------------|--|
| Beauty soap | People who buy beauty soap will be people who want to keep their skin soft. They will therefore buy soap which contains moisturisers. This will be bought mainly by women. |
| Baby soap | This is mild soap which will not harm a baby's skin. Bought mainly by mothers for their babies. |
| Medicated soap | Sometimes soap is sold to help fight acne. This tends to be bought mainly by teenagers, both male and female. |
| Non-branded soap | This is an economy product which is plain soap with no extra perfume added. This will probably be bought by people on low incomes. |

There may be other types of soap you can think of which are aimed at different groups. Sales of soap will be affected by income groups, gender and also age.



Which type of soap will each person use?

Activity 10.4

Read the case study opposite.

- List the different brands of soap sold in your local shops.
- Which segments of the market are each of these brands of soap aimed at?

Activity 10.5

Toyota produce a range of cars aimed at different market segments. They even own a separate company, called Lexus, whose cars are aimed at a particular market segment.



A Lexus IS 250



A Toyota Yaris



A Toyota Camry



A Toyota Land Cruiser

- Look at the photographs of the Toyota range of cars and identify what characteristics the consumers of these models are likely to have. The characteristics you identify might include income (socio-economic group), age, gender, use of the product, lifestyle.
- Explain the benefits to Toyota of producing a large range of cars aimed at different market segments.

Revision summary: ways of segmenting markets



International business in focus: personal computers and technology



Personal computer and mobile (cell) phone technology has seen many advances over the last twenty years.

The personal computer market has seen many changes over the last few years. The standard desktop computer is becoming a thing of the past in many offices, where a laptop has taken its place. In the home this has also been true. However, the introduction of the netbook and then the Apple iPad has changed the market again.

Predictions for the future of the personal computer market are that mobile devices will become market leaders in terms of global sales, followed by tablets and netbooks. Home computers are seen as becoming a smaller and smaller share of the global market.

Discussion points

- How has the market for personal computers changed?
- Why have these changes happened?
- How should businesses in the personal computer market respond to these changes?

Exam-style questions – Paper 1

- 1 D & F Limited own a number of farms which grow fruit. The fruit is sold to large supermarkets abroad. They also grow coffee which is sold to companies that process and brand the coffee which is also then sold to large supermarkets abroad. The world price of coffee has recently dropped by 20 per cent. There has been a growing demand for fruit from developing countries with rising incomes as well as an increasing demand from developed countries which have seen a growing trend towards 'healthy eating', encouraged by government policies to tackle their obesity problem.
- What customer needs are being satisfied by D & F Limited? [2]
 - Identify **two** reasons why the price of coffee might be falling. [2]
 - Identify and explain **two** reasons why supermarkets are demanding more fruit. [4]
 - Identify and explain **two** ways the Directors of D & F Limited could respond to increased competition from farms which now grow fruit instead of vegetables. [6]
 - Do you think D & F Limited should change production from coffee to growing more fruit? Justify your answer. [6]
- 2 TGH are a public limited company which makes sports shoes (trainers). It makes a variety of designs for the mass market. The mass market is for young people who want fashionable sports shoes as well as those who play sport. The Directors recently decided to target a niche market which is for a particular market segment of customers who have a medical problem with their feet and need specially designed shoes.
- What is meant by a 'niche market'? [2]
 - Identify **two** examples of the different markets for TGH products. [2]
 - Identify and explain **two** reasons why TGH sell to a niche market. [4]
 - Identify and explain **two** advantages to TGH of segmenting the market for sports shoes. [6]
 - Do you think the Directors of TGH were right to target a niche market or should they have stayed with just a mass market? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- the role of marketing – identifying and satisfying customer needs as well as maintaining customer loyalty
- why market changes occur, such as when spending patterns change or there is increased competition, and how businesses can respond to these changes
- the difference between mass marketing and niche marketing
- what is meant by market segmentation and why market segmentation may be used
- to recommend and justify an appropriate method of segmentation in given circumstances.

NOW – test your understanding with the revision questions on the CD-ROM.

This chapter will explain:

- the importance of market research
- what is meant by primary research
- what is meant by secondary research
- who carries out this research
- why the information collected may not be accurate
- presentation and use of market research results.

Product-orientated and market-orientated businesses

Some businesses produce the product first and then try to find a market for it. This is known as being **product-orientated**. This is not common today. Product-orientated businesses often produce basic necessities required for living, such as agricultural tools or fresh foods. These products may not have their own name or brand (brand names will be discussed later in this chapter) and are general products that consumers need to buy. The manufacturer and retailer are mainly concerned with the price and quality of the product. Sometimes when new technologies are being developed, this is done without first investigating possible markets. People may not want this product until it has been developed and advertising has persuaded them to buy it.

Businesses whose markets are national or international cannot afford to produce products and hope that they will sell, without first carrying out market research to find out if the consumers will want the product. This is called being **market-orientated** and it means that the business must have a **marketing budget**. The business has to identify the wants and desires of customers, both now and in the future, in order to produce the right goods which will sell well and make a good profit for the business.

Market-orientated businesses are better able to survive and be successful because they are usually more prepared for changes in customer tastes. They are able to take advantage of new market opportunities which may arise. New products are launched with more confidence when customer needs have been identified before the product is introduced on to the market.

Definitions to learn

A **product-orientated** business is one whose main focus of activity is on the product itself.

A **market-orientated** business is one which carries out market research to find out consumer wants before a product is developed and produced.

A **marketing budget** is a financial plan for the marketing of a product or product range for some specified period of time. It specifies how much money is available to market the product or range, so that the Marketing department know how much they may spend.

Case study example

Joshua invents a new tool for planting seeds. It is much easier to use than existing tools. However, it has high manufacturing costs, twice as much as existing tools.

Activity 11.1

Read the case study above.

- Is Joshua's business product-orientated or market-orientated? Give reasons for your answer.
- What would you advise Joshua to do before he starts to manufacture the new tool? Explain your answer.

Why is market research needed?

A business needs to find out how many people would want to buy the product it is planning to offer for sale. If there is not a very big market for the product, a great deal of money could be wasted producing something that not many people will buy. It could even cause the business to go bankrupt. Therefore, it is very important that **market research** is carried out accurately.

Market research is used to try to find out the answers to these questions.

- What feature of my product do people like or dislike?
- Would they be willing to buy my product?
- What price would they be prepared to pay?
- Where would they be most likely to buy my product?
- What type of customer would buy my product?
- What type of promotion would be effective with these types of customers?
- What is the competition like?

By carrying out market research, a business can identify customer needs in a changing and competitive international environment. This is essential if a business is to remain competitive in the future.

Types of information

Market research can find out:

- quantitative information, which answers questions about the quantity of something, for example, ‘How many sports shoes were sold in the month of December?’ or ‘What percentage of children drink a certain sort of cola?’
- qualitative information, which answers questions where an opinion or judgement is necessary, for example, ‘What do customers like about a particular product?’ or ‘Why do more women than men buy the company’s products?’

Both types of information can be gathered as a result of:

- **primary research**, or field research
- **secondary research**, or desk research.

Primary research

Primary research, or field research, is the collection and collation of original data. It involves direct contact with potential or existing customers.

This research will usually have been planned and carried out by the people who want to use the data; it is first-hand. It can be an expensive way to gather information and will usually be for a specific purpose, for example, to test the market to see if a new product would be likely to succeed.

There are various types of primary research method:

- questionnaires
- interviews
- focus groups
- observation.

Note: Questionnaires, interviews and focus groups are all different types of survey.

Definitions to learn

Market research is the process of gathering, analysing and interpreting information about a market.

Primary research is the collection and collation of original data via direct contact with potential or existing customers. Also called field research.

Secondary research is information that has already been collected and is available for use by others. Also called desk research.

A **questionnaire** is a set of questions to be answered as a means of collecting data for market research.

The process of primary research

To undertake primary research, a business will normally go through a number of stages, as summarised in the diagram below.

1 What is the purpose of the market research?

What do they want to find out? What information will be needed? What action will be taken as a result of the research? This will affect the type of market research undertaken.

2 Decide on the most suitable method of research

Will more than one method be necessary? Will just secondary research be sufficient or will primary research be needed as well? The cost of the research and the time required will need to be taken into account.

3 Decide on the size of sample needed and who is going to be asked

How big will the sample size need to be to keep costs down but get a sufficiently accurate result? Which different groups of people will need to be included in the survey? Different age groups? Different income groups?

4 Carry out the research

5 Collate the data and analyse the results

The information will need to be put together and the data analysed. What does it seem to show?

6 Produce a report of the findings

A report will need to be produced showing the findings. Included in the report will be a summary of the research findings and conclusions drawn based on these results. Recommendations should be made as to what actions are necessary as a result of the research; these should be based on the conclusions.

The stages of primary research

Methods of primary research

Questionnaires

Questionnaires form the basis of most primary research. Questionnaires may be conducted face-to-face, for example in the street, by telephone, by post or on the internet.



Online surveys

Online surveys can be carried out on specialised websites. These allow the researcher to put a questionnaire on the website. The researcher will then email people to ask them to go onto the website and complete the questionnaire.

Deciding what questions to ask is difficult if you want to be sure of getting accurate results. Some questions may not be very clear, some questions may lead the respondents to answer in a certain way which may not be what they really think. The researcher also needs to decide who to ask.

Advantages of questionnaires

- Detailed qualitative information can be gathered about the product or service.
- Customers' opinions about the product or service can be obtained.
- They can be carried out online, which makes it cheaper and easier to collate/present the results.
- They can be linked to prize draws and prize draw websites to encourage people to fill in the questionnaire.

Disadvantages of questionnaires

- If questions are not well thought out, the answers to them will not be very accurate. It may be very misleading for the business if it is thought that a product is liked by consumers, when in fact the respondents were only saying they thought the product was quite attractive but they would not actually buy it.
- Carrying out questionnaires can take a lot of time and money.
- Collating and analysing the results is also time-consuming.

Interviews

When interviews are used, the interviewer (the person asking the questions) will have ready-prepared questions for the interviewee (the person answering the questions).

Advantages of interviews

- The interviewer is able to explain any questions that the interviewee does not understand.
- Detailed information about what the interviewees like and dislike about the product can be gathered.

Disadvantages of interviews

- Whether consciously or unconsciously, the interviewer could lead the interviewee into answering in a certain way, resulting in inaccurate results due to interviewer bias.
- Interviews are very time-consuming to carry out and, therefore, they are often an expensive way of gathering information.

Interviews can be carried out with one person or they can be done in groups, where there is a single interviewer putting the questions to a group of people. This is less expensive than asking people individually, but it does run the risk of the answers from people not being what they really think, but being influenced by what the others in the group say.

Samples

When deciding who to ask to fill in a questionnaire or who to interview, a **sample** would have to be selected as it would be too expensive and impractical to try to include all the relevant population. This could be:

- a **random sample**. This means that every member of the population has an even chance of being selected. People are selected at random (often by computer), for example, every 100th name in a telephone directory. The advantage is that everyone has an even chance of being picked, but not everyone in the population may be a consumer of the particular product being investigated.

Definitions to learn

A **sample** is the group of people who are selected to respond to a market research exercise, such as a questionnaire. A **random sample** is when people are selected at random as a source of information for market research.

Definitions to learn

A **quota sample** is when people are selected on the basis of certain characteristics (such as age, gender or income) as a source of information for market research. A **focus group** is a group of people who are representative of the target market.

- a **quota sample**. This is when people are selected on the basis of certain characteristics, for example, age, gender or income. Researchers are given a quota. If they are carrying out street interviews, the researchers can choose who to interview, providing they ask a certain number of people with certain characteristics. For example, they may be required to interview 20 people from the age group 10–25, 30 people from the age group 26–45, and 20 people from the age group 46–60. The researchers can then find out the views of these specific groups.

Focus groups

This is where groups of people (**focus groups**) agree to provide information about a specific product or general spending patterns over a period of time. This helps with development and sales. Groups may also test new products and then discuss what they think of them, explaining what they like and what they dislike about them.

Advantage of focus groups

- They can provide detailed information about consumers' opinions.

Disadvantage of focus groups

- They can be time-consuming, expensive and biased if some people in the panel are influenced by the opinions of others.

Observation

This can take the form of:

- recording – for example, meters can be fitted to monitor which television channels are being watched
- watching – includes such activities as counting how many different types of vehicles pass particular billboards or posters, counting how many different types of people go into a particular shop and also come out having bought something
- audits – for example, the counting of stock in shops to see which products have sold well.

Advantage of observation

- It is quite an inexpensive way of gathering data.

Disadvantage of observation

- The information only gives basic figures. It does not provide the business with reasons for consumer decisions.

Whether questionnaires, interviews, focus groups or observation are used to find out about a product depends very much on the type of product or service in question.

Tips for success

Make sure you can select a suitable method of primary research for particular products and explain why it is suitable.

Activity 11.2

The following products require some primary research. Decide which type of research would be the most appropriate to use and why.

- a) The possible success of a new chocolate bar.
- b) Whether to introduce a new style of watch which uses fashionable bright colours.
- c) Whether to extend an existing taxi service to cover a new town.
- d) The feasibility of opening a new restaurant.
- e) Why the sales of a sports shoe are falling.

Secondary research

Secondary research, or desk research, is the use of information that has already been collected and is available for use by others. The information may be from either internal sources or external sources.

Internal sources of information

A lot of information may be readily and cheaply available from the firm's own records. Relevant qualitative information will be available from the Sales department, which will hold detailed data on which brands of products have been selling well and in which area. The Finance department could give detailed information on the costs of manufacturing products or providing services.

Examples of internal sources of information include:

- Sales department sales records, pricing data, customer records, sales reports
- opinions of distribution and public relations personnel
- Finance department
- Customer Service department.

External sources of information

This is when information is obtained from outside the company. External sources are many and varied and tend to depend on the type of product that is being researched. Information from external sources is inevitably of a general nature as it has been gathered for some purpose other than the research that is being undertaken. The data can still be useful, as long as the limitations are taken into account.

- **Government statistics** are a detailed source of general information about such things as the population and its age structure. This is available in most countries.
- **Newspapers** may have useful articles, for example, about the general state of the economy and whether customers are expected to increase or decrease their spending in the near future.
- If there is a **trade association** for the industry, it often provides information for the businesses in that industry. For example, there might be an agricultural association which helps farmers who grow particular crops.
- **Market research agencies** are specialist agencies who carry out research on behalf of companies or anyone who commissions them. They sometimes publish reports of their research into particular markets. However, whilst the reports contain very detailed information about the market, they are expensive to buy.
- The **internet** provides an easily accessible source of a very wide range of information, including information on companies from their own websites, on government statistics, newspapers, etc. In fact any paper-based sources of information can often also be easily and quickly accessed through the internet. However, care must be taken to check information as it is not always accurate.

Tips for success

Make sure you can select a suitable method of secondary research for particular products and explain why it is suitable.

Secondary research is often a much cheaper way of gathering information as the research has already been done by others. It may be needed to help assess the total size of a market by finding out the size of the population and its age structure. Newspapers may carry vital economic forecasts if you are trying to assess when a recession might end and your sales increase again. This type of information could not be obtained by primary research.



Activity 11.3

Which of the following sources of information gathered by a business are primary data and which are secondary?

| Data | Primary or secondary? |
|---|-----------------------|
| The <i>Daily News</i> article on a competitor's new product | |
| Sales department's monthly sales figures | |
| A shop's daily inventory figures showing on which days sales are at their highest | |
| A traffic count to see how many vehicles pass your billboard advertisement in a week | |
| Postal questionnaire results researching into your new product | |
| A market research agency's report on what customers like and dislike about your product | |
| Annual government population statistics | |
| Data on customer complaints | |

Case study example

Pepsi manufacture fizzy drinks. They want to start selling a new drink in your country. To help them assess the size of the market, you have been asked to find out the following information:

- size of total population
- how many people there are in the age groups 1–10, 11–20 and 21–30 in your country
- how many different fizzy drinks are sold in your country (how many competitors there are)
- where these competitors come from – are they local companies or are the drinks imported?

Activity 11.4

Read the case study above.

What other research would you advise the company to undertake before starting to sell in your country? Explain your answer.

Who carries out market research?

Businesses can carry out their own research into different aspects of the market for their existing product or the possible market for a new product. Secondary research is often easier and cheaper to carry out, as primary research may be too expensive for the business to undertake itself.

The business may decide that it can afford to pay a specialist market research agency who will carry out whatever research it is asked to do. (These agencies also carry out opinion polls to see who they predict will win political elections.) They will find out consumers' spending habits as well as what they think about an individual business's products and their competitors' products. However, they are expensive to use.

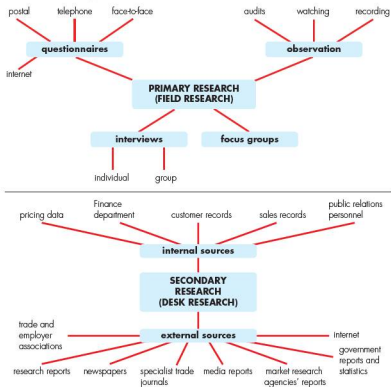
Accuracy of market research data

The reliability or accuracy of the data that has been collected depends largely on:

- how carefully the sample was drawn up
- the way in which the questions in the questionnaire were phrased to ensure honest responses
- the sample selected – it is unlikely to be truly representative of the total population, but it needs to be as near as is possible. If a quota sample is used, rather than a random sample, it is easier to get more accurate data
- the size of the sample – this is also important. It is not possible to ask everyone in a population, which is why a sample is used. The larger the sample, the more accurate the results are likely to be, but the more expensive will be the research. If only a small sample is asked, the results are unlikely to be as accurate. Therefore, the researchers need to decide how many people will give them the accuracy they want and can afford
- well-phrased questions – trying out questionnaires on a small group of people before using them on a large sample can help to see if any of the questions could be misinterpreted. The questions can then be rephrased and the revised questionnaire carried out on the main sample
- who carried out the research – secondary research may not be as accurate as first thought because it was initially carried out for some other purpose and you would not know how the information was actually gathered
- bias – articles in newspapers sometimes have a bias and important information is left out deliberately
- age of the information – statistics can quickly become out of date, no longer relating to current trends in consumers' buying habits, but reflecting what they used to be spending their money on.

These are just some of the reasons why information collected from all sources, both primary and secondary, should be used with care. It should never be assumed straightaway that information is correct.

Revision summary: methods of market research



Activity 11.5

Copy out the table below and fill in the boxes.

Advantages and disadvantages of different types of market research

| Method | Examples | Advantages | Disadvantages | Examples of appropriate use | Why the information may not be accurate |
|--------------------|------------------|------------|---------------|-----------------------------|---|
| Primary research | Questionnaires | | | | |
| | Interviews | | | | |
| | Observation | | | | |
| | Focus groups | | | | |
| Secondary research | Internal sources | | | | |
| | External sources | | | | |

How to design and use a questionnaire

Tips for success

Make sure you can explain how to carry out a questionnaire and explain why each of the stages is important in gaining accurate information.

Ask yourself the following questions.

- What do I want to find out?
- Who do I need to ask? (Age group, male/female, particular income or occupations)
- Where will I carry out my questionnaire?

Writing the questions

- When deciding what questions to ask, it is advisable to ask no more than 12 questions.
- Keep the questions short and clear. It is a good idea to keep the answers simple too, for example, ask for yes/no answers or provide a choice from which the respondents have to choose.
- If you want to know the age of the interviewee, give a choice of age groups, for example 21–40.
- Avoid open-ended questions unless people's opinions are sought.
- Be careful not to lead the interviewee into an answer that may not be true by asking too direct a question.
- Think about the order in which you ask the questions. Be logical!

Carrying out the questionnaire

Before going out and asking the questions, think about how you will ask the questions and how you are going to record the results. You may need to create a grid to put the respondents' replies on.

- How many people are you going to ask?
- At what time of the day are you going to carry out the questionnaire? Will this affect who will answer the questions?
- Where are you going to carry out the questionnaire? Will this have an influence on who you ask?

Case study example

On the next page are some of the results of a questionnaire that was carried out to look into the feasibility of opening a fast food restaurant in a city centre. One hundred people were asked at random to answer the questionnaire. The aim of the questionnaire was to identify the particular market segment to be targeted in any promotional campaign.

(continued)

Case study example (continued)

| | | | |
|-------|--|-------------------------|-----------------|
| (i) | Responses to question 1: | Age group (years): | No. of persons: |
| | Age structure of persons in the sample | 0–9 | 5 |
| | | 10–19 | 40 |
| | | 20–29 | 20 |
| | | 30–39 | 20 |
| | | 40–49 | 10 |
| | | 50+ | 5 |
| (ii) | Responses to question 2: | Response: | No. of persons: |
| | 'How often do you eat out?' | Never | 5 |
| | | Occasionally | 20 |
| | | Once per month | 30 |
| | | Once per week | 20 |
| | | More than once per week | 25 |
| (iii) | Responses to question 3: | Response: | No. of persons: |
| | 'Where do you purchase meals most often?' | Hotel | 20 |
| | | Café | 15 |
| | | Fast food restaurant | 35 |
| | | Food stalls (in street) | 25 |
| (iv) | Responses to question 4: | Response: | No. of persons: |
| | 'How far do you usually travel when eating out?' | 1 km | 30 |
| | | 2 km | 40 |
| | | 5 km | 12 |
| | | 5–10 km | 8 |
| | | over 10 km | 5 |

Activity 11.6

Analyse the results in the case study above and answer these questions.

- Which age group would be most likely to eat in fast food restaurants?
- How will this information affect where the business will advertise their restaurant?
- Why did the questionnaire contain the question 'How often do you eat out?'
- How will the responses to questions 2 and 3 be useful to the fast food restaurant?
- Suggest two additional questions that could have been included in the questionnaire. Explain why the information they provide would be useful to the business.
- Explain why the questionnaire results might not be very accurate.

Presentation of data from market research

When information has been gathered as part of market research, it may be difficult to make sense of what it means. The raw data will need to be converted into a form which is easy to understand. The significant points need to be made clear. For example, after conducting a questionnaire, it may not be clear which answer has the greatest number of 'yes' responses.

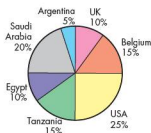
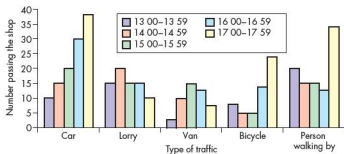
The type of data that has been collected and what it is to be used for will affect the form of presentation which will be used. Information can be displayed in the form of:

- a table or tally chart – usually used to record the data in its original form, however, it is often better to convert the data into a chart or graph

An example of a tally chart

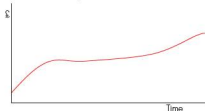
| Time | Car | Lorry | Van | Bicycle | Person walking by |
|-------------|-----|-------|-----|---------|-------------------|
| 13 00–13 59 | | | | | |
| 14 00–14 59 | | | | | |
| 15 00–15 59 | | | | | |
| 16 00–16 59 | | | | | |
| 17 00–17 59 | | | | | |

- a chart – shows the total figures for each piece of data or the proportion of each piece of data in terms of the total number. For example, if a company sells its product in several countries, a chart can show at a glance which countries have the biggest percentage of sales and which have the lowest



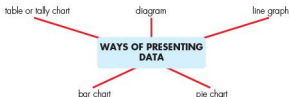
A bar chart and a pie chart

- a graph – used to show the relationship between two sets of data. For example, how total cost changed over a number of years. The two variables are ‘total cost’ and ‘time’.



A line graph

Revision summary: presentation of data from market research



Activity 11.7

You have been asked to carry out some research into the feasibility of opening a new restaurant in your local area. Design your own questionnaire to carry out on friends and/or family.

Complete the following steps.

- Design the questionnaire.
- Decide who you are going to ask.
- Decide how many people you are going to ask (it is a good idea to carry out the questionnaire with friends and then put the results together so that you have a greater number of replies).
- Produce a summary sheet on which to collate the results.
- Collate the results.
- Present the results you have found.
- Evaluate your findings. What does the data tell you? Should a new restaurant be opened? If so, what type of restaurant would be successful?
- Evaluate your questionnaire. How accurate were your results? Would you redesign the questionnaire if you were carrying out the research again?

International business in focus: mobile phone technology

Mobile phone companies are hoping to increase profits with the introduction of an ‘app’ which will allow the use of your phone as a wallet. This will allow payments in such places as shops and restaurants, to be made using your mobile phone. Some of the options allow for multiple credit card numbers to be stored in a single phone. However, consumers, retailers, banks and credit card companies have expressed some concerns over the new technology, especially over security.

Discussion points

- How could the mobile phone companies find out what consumers, retailers, banks and credit card companies think about the new technology?
- Do you think it is necessary, before launching this app, for this market research to be done?

Exam-style questions – Paper 1

- 1 T & T is a small business which sells many different types of garden tools. Sales of its products are growing very quickly. Its Managing Director (MD) feels that market research isn't the most important factor contributing to the success of the business. However, the MD does want primary market research to be carried out before developing a new type of garden tool.
- What is meant by 'primary research'? [2]
 - Identify **two** methods of primary market research. [2]
 - Identify and explain **two** ways of presenting market research data on existing products that T & T could use. [4]
 - Identify and explain **two** factors which should be taken into account by T&T when trying to ensure the research information is accurate. [6]
 - Do you think market research is necessary before T & T develop a new product? Justify your answer. [6]
- 2 H & H have recently designed a new 'app' for the iPhone. People in many different countries will be likely to want to download this app. The MD wants the Marketing department to carry out secondary research rather than primary research before launching this new 'app'.
- What is meant by 'secondary market research'? [2]
 - Identify **two** examples of secondary market research data which could be used by H&H. [2]
 - Identify and explain **two** advantages to H&H of using secondary market research. [4]
 - Identify and explain **two** reasons why accurate market research information is important to H&H. [6]
 - Do you think the MD is right to want to only carry out secondary research? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- to identify when primary or secondary research would be suitable to gather data for a particular purpose
- how to conduct your own market research – primary or secondary (be able to construct a questionnaire, carry out the questionnaire and analyse the data gathered)
- to evaluate whether data is accurate or biased
- how to present market research results.

NOW – test your understanding with the revision questions on the CD-ROM.

The marketing mix: product

This chapter will explain:

- the four elements of the marketing mix
- the role of product decisions in the marketing mix
- the costs and benefits of developing new products
- brand image and how this can influence sales and customer loyalty
- the role of packaging
- the product life cycle
- how stages of the product life cycle can influence marketing decisions
- how the product life cycle can be extended.

Definitions to learn

The **marketing mix** is a term which is used to describe all the activities which go into marketing a product or service. These activities are often summarised as the four Ps – product, price, place and promotion.

The marketing mix

The **marketing mix** is a term which is used to describe all the activities which go into marketing a product (remember that this includes goods and services).

The producer might need to find out through market research what customers want from the product, then they may change the product to produce what consumers want. Once this is achieved, the producer has to convince the consumers that their product is the one that they want and that it meets their needs better than any of their competitors' products. Producers do this by branding their product. This involves giving a product a unique name and packaging. It is then advertised to make consumers believe that it is different to any of the competitors' brands. The product also has to be sold in places that reinforce the brand image.

All of these activities are part of the marketing mix for a product. They are often summarised as the four Ps.

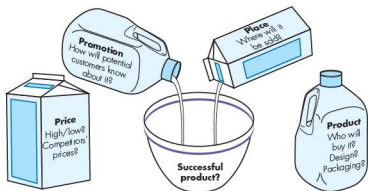
The four Ps of the marketing mix

- **Product.** This applies to the product itself – its design and quality. How does the product compare with its competitors' products? What is the packaging like?
- **Price.** This is the price at which the product is sold. A comparison must be made with the prices of competitors' products. Price should, in the long run, cover costs (see Chapter 13).
- **Place.** This refers to the channels of distribution that are selected. That is, what method of getting the product to the market is to be used? Will the manufacturer sell their product to shops who sell to the public, or to wholesalers, or direct to the customers? (See Chapter 15.)
- **Promotion.** This is how the product is advertised and promoted. What types of advertising media will be used? It includes discounts that may be offered or any other types of sales promotion, such as money-off vouchers or free gifts (see Chapter 14).

Some people also talk about packaging as being a fifth P, but it can be included as part of both product and promotion.

Each part of the marketing mix has to be considered carefully to make sure that it all fits together and one part does not counteract the other. For example, a high-priced perfume should be wrapped in expensive-looking packaging and advertised by glamorous women, but then it should not be sold in small food stores. If it were, the 'Place' would not fit in with the other parts of the marketing mix.

Revision summary: the marketing mix



The role of product decisions in the marketing mix

The product itself is probably the most important element in the marketing mix – without the product, the rest of the marketing mix is pointless. As discussed in Chapter 11, some businesses are product-orientated, that is, they will develop a product and then try to decide who might buy it. Today most companies are market-orientated when developing new products. They spend a lot of money researching consumers' buying habits, their likes and dislikes, to see if they can design a product which people will want to buy. After deciding the market segment for the product, the other parts of the marketing mix – price, place and promotion – will be determined.

Large companies often have a department which spends all its time developing new products. It will also look at competitors' products to see what they are successfully selling.

Types of product

There are several types of product. Some products are sold to consumers and some can be sold to other businesses (that is, to other producers). In addition to goods, services are also sold to consumers and to other producers. Products are usually grouped into the following types.

- **Consumer goods.** These are goods which are consumed by people. They can be goods that do not last long, such as food and cleaning materials. Some goods last a relatively long time and give enjoyment over a long time, such as furniture and computers.
- **Consumer services.** These are services that are produced for people. Examples include repairing cars, hairdressing and education.
- **Producer goods.** These are goods that are produced for other businesses to use. They are bought to help with the production process. Examples include lorries, machinery and components.
- **Producer services.** These are services that are produced to help other businesses. Examples include accounting, insurance and advertising agencies.

Activity 12.1

Copy this table and tick the correct box for each product.

| Product | Consumer good | Consumer service | Producer good | Producer service |
|---------------------------------|---------------|------------------|---------------|------------------|
| Tube of toothpaste | | | | |
| Bottle-filling machine | | | | |
| Bank accounts | | | | |
| A pair of sports shoes | | | | |
| A chocolate bar | | | | |
| Doctor's treatment of a patient | | | | |
| Office cleaning | | | | |
| Factory building | | | | |
| Purchase of a hospital bed | | | | |
| Television programme | | | | |

Defining the type of product the business is producing is important when deciding how the product will be developed and marketed.

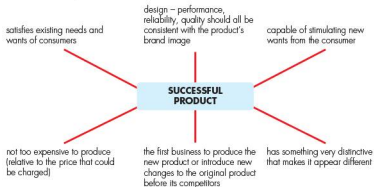
Promotion of a producer good will be quite different to promotion of a consumer good – this is discussed in Chapter 14.

Producing the right product at the right price is an important part of the marketing mix.

- The product needs to satisfy consumer wants and needs. If it does not then it will not sell.
- The product also needs to be of the right quality so the price is what consumers are willing to pay.
- The costs of production must enable a price to be set that will produce a reasonable profit.

- Design of the product is obviously very important. Not only does the quality need to be appropriate for the brand image (that is, high price for high quality, cheaper price for lower quality) but it also has to last a reasonable length of time. If the product is not reliable and breaks down, or breaks soon after it is purchased, then it will get a bad reputation and is unlikely to sell well. The product also needs to perform to a standard expected from it (for example, soap powder for washing clothes should do so effectively!).

What makes a product successful?

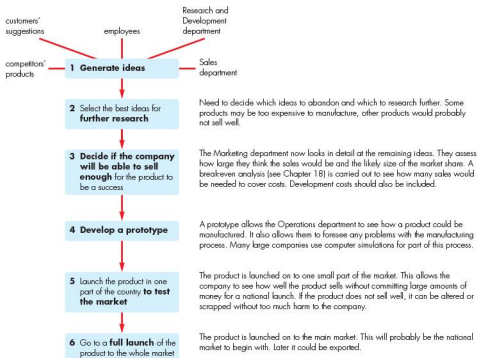


Activity 12.2

- Choose three products that you have bought.
- Do you think they have been successful? Why?
- Try to analyse the success of each product using the criteria in the diagram above. For example, does it have a good design? Is it reliable? Is it very distinctive from other brands?

Product development

Large businesses are looking for new products all the time. Smaller businesses are also trying to stay competitive and therefore need to keep up with other companies. When developing a new product, most businesses go through the process outlined on the following page.



Activity 12.3

You work for a company which manufactures ice cream. You have been given the task of designing a new ice cream on a stick (a lolly) suitable for small children. Describe in detail how you would do this.

The costs and benefits of developing new products

Definitions to learn

The **USP** is the special feature of a product that differentiates it from the products of competitors.

There are various benefits for the business when developing new products. These are as follows:

- **USP (Unique Selling Point)** will mean the business will be first into the market with the new product
- diversification for the business, therefore giving it a broader range of products to sell
- it allows the business to expand into new markets
- it may allow the business to expand into existing markets.

However, there are also costs for the business when developing new products. These are as follows:

- the costs of carrying out market research and analysing the findings
- the costs of producing trial products including the costs of wasted materials
- lack of sales if the target market is wrong
- loss of company image if the new product fails to meet customer needs.

The importance of brand image

Definitions to learn

The **brand name** is the unique name of a product that distinguishes it from other brands.

Brand loyalty is when consumers keep buying the same brand again and again instead of choosing a competitor's brand.

Brand image is an image or identity given to a product which gives it a personality of its own and distinguishes it from its competitors' brands.

Selling a product directly to the customer makes it easy to inform the customer of the product's qualities and good points. The salesperson can persuade the customer to buy the product. If a small business produced handmade jewellery and sold it on a street stall, it could be explained to customers how the jewellery was made and why it was a good product to buy.

Today, the manufacturers of most products do not sell them directly to the customer – they are sold to other businesses or retailers, who sell them on to the customer. This means that the product's unique features and the reasons for buying it must be conveyed in a different way. This is done by creating a brand for the product. It will have a unique name, a **brand name**, and advertising will need to make consumers aware of the qualities of the product to try to persuade them to buy it. Branded products are normally sold as being of higher quality than unbranded products. It is the assurance of a standard quality that makes consumers confident in buying branded products.

Businesses use brands for their products to encourage consumers to keep buying their products and not those of their competitors. Consumers may have **brand loyalty**, which means they will keep buying the same brand of a product instead of trying other similar products.

Brand image is important. The brand is more than just an assurance of guaranteed quality, it will have a whole image which surrounds it and will be reinforced by advertising. Coca-Cola, for example, is sold throughout the world and has an image of being a superior quality cola drink which tastes better than its rivals' drinks. Advertising shows people having fun when they drink it and emphasises that it is a fashionable drink for young people.

Tips for success

Make sure you can choose suitable packaging for different products to ensure the correct appeal for the brand image/target market.

Case study example



Nestlé manufacture chocolate bars. One of their bestselling bars is Milkybar which appeals to young children. On the front of the packaging there is a picture of a smiling cowboy – called the Milkybar kid. The advertising will be on television and the adverts will feature the Milkybar kid – he will be a friendly, likeable character. The image of the chocolate bar will be embodied in the Milkybar kid as he has been created to appeal to young children.

Discussion points

- Which consumers are the target market for Milkybars?
- Explain how the packaging appeals to the target market.
- Describe the brand image for Milkybars and explain how the marketing of Milkybars develops this brand image.

Revision summary: branding



Activity 12.4

Select two products that have brand names. For each of the products identify:

- who the customers of the product are
- what it is that attracts them to the product
- what brand image the manufacturer is trying to create
- how the name and the packaging of the product help to reinforce the brand image
- where it is sold.

Definitions to learn

Packaging is the physical container or wrapping for a product. It is also used for promotion and selling appeal.

The role of packaging

Getting the **packaging** right is just as important as getting the other parts of the marketing mix right. The packaging has two functions to perform.

It has to be suitable for the product to be put in. Packaging has to give protection to the product and not allow it to spoil. It also has to allow the product to be used easily. It is no good having hair shampoo in a tin which will not allow the liquid to pour out easily. It has to be suitable for transporting the product from the factory to the shops, so preferably the packaging should not be too delicate or the product could easily get damaged.

Packaging is also used for promoting the product. It has to appeal to the consumer, therefore the colour and shape of the container is very important. It is the packaging that catches the customer's eye, not usually the product inside! The brand image will be reinforced by the packaging in which the product is sold. An expensive product will have a luxurious-looking container, often a gold colour. A low-cost product may have basic simple packaging with plain colours.

The labels on products sometimes have to carry vital information about the product, such as how to store or use it and what ingredients it contains.

Case study example



Kellogg's manufacture breakfast cereals. The packaging used is bright and colourful and has the brand name clearly printed on the front of the packet in large letters. The outer packet is made of cardboard to keep its shape, so it will stand up on the shelves in shops and prevent the contents from being crushed. The side of the packet contains information about the nutritional qualities of the product. There is also sometimes a special offer printed on the outside of the packet to encourage consumers to buy the cereal. There are sometimes tokens on the packet to be cut out, collected and then sent off to receive a free gift. The cardboard packet has inner packaging to keep the product sealed in and fresh until it is purchased and consumed by the customer.

Revision summary: packaging



Case study example



S & B Food Products plc have decided to produce a new fruit-flavoured milk drink especially for young children. The market segment that it expects to buy the product is parents, for their children. It is a healthy drink which contains vitamins and minerals.

Activity 12.5

Read the case study above.

- Which of the possible containers drawn above would you use for the new fruit-flavoured milk drink? Explain your choice.
- Suggest another container that might be more suitable for the new milk drink.
- What colour(s) should the container be? Explain your choice.
- Choose a brand name for the new milk drink. What image does the name give to the product?
- Design a label for the container. Why do you think the design of the label will help the product to sell?
- What information will need to be put on the label?

The product life cycle

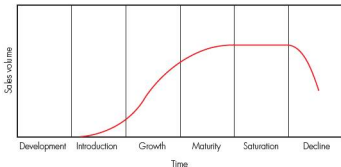
Products do not last forever. A typical cycle for a product is as follows.

- 1 First a product will be **developed**. The prototype will be tested and market research carried out before the product is launched on to the market. There will be no sales at this time.
- 2 It is then **introduced** or launched on to the market. Sales will grow slowly at first because most consumers will not be aware of its existence. Informative advertising is used until the product becomes known. Price skimming (see Chapter 13) may be used if the product is a new development and there are no competitors. No profits are made at this point as development costs have not yet been covered.
- 3 Sales start to **grow** rapidly. The advertising is changed to persuasive advertising to encourage brand loyalty. Prices are reduced a little as new competitors enter the market and try to take some of your customers. Profits start to be made as the development costs are covered.
- 4 **Maturity**. Sales now increase only slowly. Competition becomes intense and pricing strategies are now competitive or promotional pricing (see Chapter 13). A lot of advertising is used to maintain sales growth. Profits are at their highest.
- 5 Sales have reached **saturation** point and stabilise at their highest point. Competition is high but there are no new competitors. Competitive pricing is used. A high and stable level of advertising is used, but profits start to fall as sales are static and prices have to be reduced to be competitive.
- 6 Sales of the product will **decline** as new products come along or because the product has lost its appeal. The product will usually be withdrawn from the market when sales become so low and prices have been reduced so far that it becomes unprofitable to produce the product. Advertising is reduced and then stopped.

Definitions to learn

The **product life cycle** describes the stages a product will pass through from its introduction, through its growth until it is mature and then finally its decline.

This process of what happens to a product is called the **product life cycle**. It is usually drawn as a graph like the one below.



A typical product life cycle

The exact length of the life cycle, in terms of time, varies a great deal from product to product. It is affected by the type of product, for example, fashionable items will go out of fashion quickly whereas food products may last a very long time. The life cycle of some very popular brands, such as Coca-Cola, is many years, whereas the life cycle of fashionable clothes is often less than a year. New developments in technology will make original products obsolete and their life cycle will come to a quick end as new products are purchased in preference to old technology.

How stages of the product life cycle influence marketing decisions

Knowing the stage of the life cycle that a product is in can help a business with pricing and promotion decisions. Prices are likely to be higher in the growth stage than in the saturation or decline stage, when the business will want to try to stop sales declining. Spending on promotion will be higher at the introduction stage than in other stages as the business has to inform consumers of the product, establish a brand identity and encourage rapid increases in sales. Advertising would probably be reduced in later stages.

Case study example

Compute plc invented a new computer game. It had been developed over several months before it was finally launched on to the market. Initially it was expensive, being bought by only a few people who wanted to be the first to play the new game. It quickly became successful – a lot of advertising was used to promote the game and sales grew rapidly. Over the next few months, more and more shops ordered copies of the game and competition between the shops was fierce. The shops offered the game at cheaper and cheaper prices to attract customers and prices for the game started to fall. Sales grew steadily now, not at the fast rates of increase that were first seen. Once most computer users had purchased the game, the market was saturated and sales began to fall, even though prices by now were low. The game was making little or no profit for the company and so they decided to withdraw the game from sale and concentrate on the new games that they had introduced.

Activity 12.6

Read the case study above.

Draw the product life cycle for the game invented by Compute plc. Label the diagram with the different stages that the game went through.

Tips for success

Make sure you can identify the stages of the product life cycle for a particular product.

Extending the product life cycle

When a product reaches the maturity or saturation stage of its product life cycle, a business may stop sales starting to fall by adopting extension strategies. These are ways that sales may be given a boost. Some possible ways businesses might extend the life cycle of their products are shown in the diagram below.

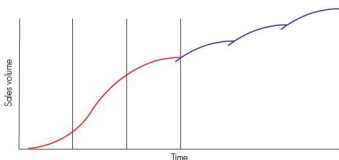


Product life cycle extension strategies

Tips for success

Make sure you can select suitable extension strategies for particular products.

If the extension strategies are effective, the maturity phase of the product life cycle will be prolonged. An example of what might happen is shown in the diagram below.



The effect of extension strategies

Businesses will not usually manufacture just one product. They will have a range of products at different stages of the product life cycle. For example, a business will need to have products coming up into the growth phase to counteract those that are in decline.

Activity 12.7

Suggest possible ways to extend the product life cycles of the following products. State which extension strategy you would use for each product, and explain why you think it would be successful in boosting sales.

- A chocolate bar which has been sold for many years in the same packaging and has had the same brand image. There are several competitors' brands of chocolate bars also sold in the market and sales have stabilised.
- A sports shoe that is worn when playing a particular sport. This sport is no longer very popular with young people.
- The sales of a new model of a car have stagnated. The car is only sold in the home country where it is manufactured.
- A children's toy which is only sold in toy shops and saw steady growth in its sales, but now the sales are stable and not increasing any further.

International business in focus: smartphones



The Apple iPhone®, a smartphone, was first launched by Apple in January 2007 in North America and when it went on sale it quickly sold out. The production and sales of the iPhone® continued to have increasing growth each year, and it is now marketed and sold all around the world. In 2012 it reached its sixth generation with the iPhone® 5. Each version has a better performance and offers more features than the previous version. There is fierce competition from other smartphones based around Microsoft and Android operating systems.

Discussion points

- What stage of the product life cycle do you think the iPhone® has reached?
- Why does Apple keep bringing out new versions of the iPhone®?

Exam-style questions – Paper 1

- 1 ABC is a private limited company. It makes nuts and bolts, which are producer products, and they are sold to large car manufacturers. The sales of its products are at a high and steady level. The products are made to the exact specifications of the car companies and they are not sold to any other customers. Some other makers of nuts and bolts have developed new products using new technology materials.
- What is meant by the term 'producer product'? [2]
 - ABC makes nuts and bolts. Identify **two** other examples of producer goods. [2]
 - Identify and explain **two** characteristics of the packaging of ABC's products. [4]
 - Identify and explain **two** benefits to ABC of only selling to large car companies. [6]
 - Do you think ABC should consider bringing out a new product? Justify your answer. [6]
- 2 XYZ produce chocolate bars and sell them to supermarkets. Its bestselling brand is ChocDelight. It is put in expensive packaging and is sold as a luxury product. This bestselling chocolate bar has had high and steady sales for the last five years, but recently sales have started to fall as it has now reached the decline stage of the product life cycle.
- What is meant by a 'brand'? [2]
 - Identify **two** ways the business could react to the falling sales of the chocolate bars. [2]
 - Identify and explain **two** characteristics of the packaging of the chocolate bars. [4]
 - Identify and explain **two** possible reasons why XYZ's chocolate bars are successful. [6]
 - Do you think giving the chocolate bar a brand name was necessary for its success? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- to identify the four elements of the marketing mix
- about the role of product decisions in the marketing mix
- what makes a product successful
- the costs and benefits of developing a new product
- what is meant by brand image and how this can influence sales and customer loyalty
- about the role of packaging
- to draw and interpret a product life cycle
- about the different stages of the product life cycle and how they can influence marketing decisions
- to suggest different ways to extend the product life cycle.

NOW – test your understanding with the revision questions on the CD-ROM.

The marketing mix: price

This chapter will explain:

- the role of pricing decisions in the marketing mix
- the main methods of pricing and the benefits and limitations of these methods
- the difference between price-elastic demand and price-inelastic demand
- the importance of price elasticity of demand in pricing decisions.

The role of pricing decisions in the marketing mix

When deciding a price for an existing product or a new product, the business must be very careful to choose a price which will fit in with the rest of the marketing mix for the product. For example, if a new product is of high quality, is to be aimed at consumers who have a lot of money, is wrapped in luxurious packaging, but has a low price, consumers will not think it is a good quality product and will not buy it. Some products are sold in very competitive markets and prices will have to be set near to their competitors' prices. Other products are the only ones available in their market and so consumers may be willing to pay a high price to have one of these products.



Example of a high-priced product and a low-priced product

Pricing strategies

If the product that is manufactured can easily be distinguished from other products in the market then it is probably a branded product. If the product is branded, it will have a distinctive name and packaging, and be aimed at a particular part of the market. It will be important to select an appropriate price to complement the brand image; a value-for-money brand should have a low price. Today many products have a brand image. Price will not just be determined by demand and supply in the market. The producer will have a lot of influence over the price of the product.

If a product has a lot of competitors in its market, the price it charges will be very important. The business must constantly monitor what its competitors are charging for their products to make sure its prices remain competitive.

A business can adopt new pricing strategies for several reasons:

- to try to break into a new market
- to try to increase its market share
- to try to increase its profits
- to make sure all its costs are covered and a particular profit is earned.

The business objective being sought will affect which of the pricing strategies the business decides to use. The price the business chooses to charge may not be related to the cost of manufacturing the product. Sometimes they might charge what they think the consumer will pay and this may be well above what it has cost them to manufacture the product.

The main methods of pricing

Cost-plus pricing

Cost-plus pricing involves estimating how many of the product will be produced, then calculating the total cost of producing this output and finally adding a percentage mark-up for profit.

- The method is easy to apply.
- You could lose sales if the selling price is a lot higher than your competitor's price.

For example, if the total cost of making 2 000 chocolate bars is \$2 000 and you want to make a 50 per cent profit on each bar, you would need to use the following calculation:

$$\frac{\$2\,000}{2\,000} + 50\% + \$1.50 \text{ per bar is the selling price}$$

$$(1 + 0.50 = \$1.50)$$

The calculation to find 50 per cent of $\frac{\$2\,000}{2\,000}$ is as follows:

$$\frac{\$2\,000}{2\,000} \times \frac{50}{100} = 1 \times \frac{50}{100} = 0.50$$

$$\left(\frac{\text{Total cost}}{\text{output}} \times \% \text{ Mark-up} = \text{Mark up} \right)$$

Definitions to learn

Cost-plus pricing is the cost of manufacturing the product plus a profit mark-up.

Definitions to learn

Competitive pricing is when the product is priced in line with or just below competitors' prices to try to capture more of the market.

Competitive pricing

Competitive pricing involves putting prices in line with your competitors' prices or just below their prices.

- Sales are likely to be high as your price is at a realistic level and the product is not under- or over-priced.
- In order to decide what this price should be, you would have to research what price your competitors are charging, and this costs time and money.

For example, a company wants to sell a brand of soap powder. It needs to sell it at a similar price to all the other brands available or consumers will buy their competitors' brands.

Definitions to learn

Penetration pricing is when the price is set lower than the competitors' prices in order to be able to enter a new market.

Price skimming is where a high price is set for a new product on the market.

Promotional pricing is when a product is sold at a very low price for a short period of time.

Psychological pricing

Psychological pricing is an approach when particular attention is paid to the effect that the price of a product will have upon consumers' perceptions of the product.

- This might involve charging a very high price for a high-quality product so that high income customers wish to purchase it as a status symbol.
- It could also involve charging a price for a product which is just below a whole number, for example, 99¢ is just below \$1 and creates the impression of being much cheaper.
- Supermarkets may charge low prices for products purchased on a regular basis and this will give customers the impression of being given good value for money.
- It ensures that sales are made by reinforcing consumers' perceptions of the product – this may be its brand image when the price is set high.
- Little sales revenue is lost by putting the price just below the price the business wants to sell the product for.
- The competitors may do the same and so reduce its effect.

Penetration pricing

Penetration pricing would possibly be used when trying to enter a new market. The price would be set lower than the competitors' prices.

- It ensures that sales are made and the new product enters the market.
- The product is sold at a low price and therefore the profit per unit sold may be low.

For example, a company launches a new chocolate bar at a price several cents below the prices of similar chocolate bars that are already on the market. If this is successful, consumers will try the new bar and will become regular customers.

Price skimming

With **price skimming**, the product is usually a new invention, or a new development of an old product, and therefore it can be sold on the market at a high price and people will pay this high price because of the novelty factor. The product will often have cost a lot in research and development, and these costs need to be recouped. Sometimes the high price can be due to the high quality of the product.

- Skimming can help to establish the product as being of good quality.
- It may put off some potential customers because of the high price.

For example, a new computer games system is invented. It will be sold in the shops at a very high price, much higher than the existing computer games systems. Because it is new and has better graphics than the old systems, consumers will be willing to pay the high price. This way the business will earn high profits which will make the research and development costs worthwhile.

Promotional pricing

Promotional pricing would be used when you want to price the product at a low price for a set amount of time.

- It is useful for getting rid of unwanted stock that will not sell.
- It can help to renew interest in a business if sales are falling.
- The sales revenue will be lower because the price of each item will be low.

For example, at the end of summer, a shop might have a lot of summer clothes left unsold. It might have a sale offering 'Buy one, get one free'. This will encourage customers to buy one item in order to get the second one free and it will clear the end-of-season stock. However, the shop will not make much, if any, profit on the clothes. But at least it will get some money for clothes that it might not otherwise have been able to sell at all.

Dynamic pricing

Dynamic pricing happens when customers are split into two or more groups and they are charged different prices for basically the same product or service because they have different demand levels. Firms do this because the price sensitivity of these two groups is different. Some customers will be very price sensitive and firms will need to be careful not to put the price too high or they will lose customers. In contrast other customers, often business customers, are not price sensitive and firms can charge a higher price. For example, airlines regularly use dynamic pricing and charge different prices for flights to the same airport at different times of the day or different times of the year. Ask your parents if the price of flights is the same during the school holidays as during term time.

Dynamic pricing can also be used to reflect the level of demand, i.e. if demand increases then the price will be raised and at times of low demand then the price will be reduced. For example, at American football games ticket prices often change to reflect the increased demand for tickets at popular games and when the game is less popular the price is reduced to encourage sales and fill the stadium seats.

Some effects of dynamic pricing are:

- increased sales revenue
- increased profit
- ensuring all seats are filled e.g. on airlines, football games
- high cost of constantly changing prices for business
- high cost for customers in terms of time spent trying to find the best price.

Tips for success

Make sure you can select suitable pricing strategies for particular products and explain why each is suitable.

Case study example

Coca-Cola is a large company that produces soft drinks. It has developed a new drink which contains an ingredient that gives people energy when they drink it. The company decided to target young people who like to go out dancing. They put the drink in a new shaped bottle which had bright colours on the outside so that it would be easily identified. The drink was advertised regularly on TV and was shown as a fashionable drink for young people. Teenagers were shown as happy, lively and enjoying life. The drink had a clearly identified brand name and was sold at a higher price than the other soft drinks that young people drink.

The company had developed a clear brand image for the product and spent a lot of money advertising the drink. As the product was new, fashionable and different, it could charge a high price for it.

Coca-Cola also manufacture a traditional soft drink that is consumed mainly by children. Sales have been falling due to more varieties of soft drinks becoming available. The company decide to reduce the price for a few months to try to attract the lost customers back.

The company uses pricing strategies to help it fulfil different aims at different times. The same product could have a very low price when entering a new market, until it is established, and then it might put prices similar to competitors' prices for a while.

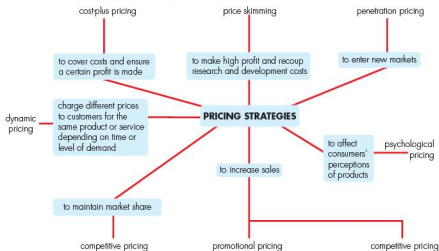
Activity 13.1

Read the case study on page 171.

Identify the different pricing strategies that Coca-Cola uses and explain when it uses them.

There are ethical issues with some examples of dynamic pricing because thanks to new technology firms can track the buying history of customers and then charge higher prices for products when they buy them (these products) online. This is compared to other customers who appear to have lower income from their past buying history; these customers are charged lower prices for the same product.

Revision summary: pricing strategies



Activity 13.2

What pricing strategy would most probably be used for the following products? Explain your choice in each case.

- A watch that is very similar to other watches sold in the shops.
- A new type of mobile phone that has been developed and is a lot higher quality than existing mobile phones.
- A chocolate bar which has been on the market for several years and new brands are being brought out which are competing with it.
- A shop, which sells food, wants to get its money back on buying the stock and make an extra 75 per cent as well.
- A new brand of soap powder is launched (there are already many similar brands available).
- A toy sold for \$1.99.
- A tour operator sells holidays during the school holidays as well as other times of the year.

Activity 13.3

Copy out the table and fill in the blank boxes.

| Pricing strategy | Examples and when they might be used | Advantages | Disadvantages |
|-----------------------|--------------------------------------|------------|---------------|
| Cost-plus pricing | | | |
| Competitive pricing | | | |
| Psychological pricing | | | |
| Penetration pricing | | | |
| Price skimming | | | |
| Promotional pricing | | | |
| Dynamic pricing | | | |

Definitions to learn

Price elasticity is a measure of the responsiveness of demand to a change in price.

Tips for success

Make sure you understand the difference between price-elastic and price-inelastic demand. Make sure you can explain how elasticity can affect pricing decisions of businesses.

Price elasticity of demand

How responsive the demand for a product is to changes in price is affected by how many close substitutes there are. If there are many close substitutes for the product then, even if its price rises only a small percentage, consumers will respond by buying the substitute product and so demand for the original product will fall by a larger percentage. For example, if the price of a chocolate bar rose by 5 per cent, some customers would buy alternative chocolate bars and sales might fall by 15 per cent. This product would be said to have **price-elastic demand** – the percentage change in quantity demanded is greater than the percentage change in price.

Prices increase by 5% then sales decrease by 15% = falling revenue for the business.

If, however, there are not really any substitutes for a product, for example, petrol, then an increase in price of 15 per cent will not cause much of a fall in sales – perhaps 5 per cent – as most consumers will carry on buying the product at the higher price. Such products are said to have a **price-inelastic demand** – the percentage change in quantity demanded is less than the percentage change in price.

Prices increase by 15% then sales decrease by 5% = increasing revenue for the business.

Therefore if the demand for the products of a business is price elastic then it is not a good idea to raise prices unless there has been rising costs. If the price elasticity of demand is inelastic then businesses can increase revenue by increasing prices.

International business in focus: petrol prices

Indian oil companies, such as Indian Oil Corporation, have raised petrol prices by 10 per cent in response to a surge in global oil prices. Prices for oil have been rising rapidly in recent months on world markets for crude oil. Local people were quoted saying, 'We will all have to be very cautious as to how we use our cars now because it will be very expensive to run a car.' Price elasticity of demand is said to be inelastic.

Discussion points

- Why have petrol prices risen?
- What effect do you think the increase in the oil price will have on the revenue made by the oil companies?

Exam-style questions – Paper 1

- 1 A & B is a private limited company. It produces a breakfast cereal which has a price-elastic demand. The costs of producing each box of cereal is \$1. The cereals are sold in shops at a price of \$2 per box. The prices of competitors' cereals range from \$1.90 to \$2.50 a box. The Marketing Manager says 'we should change to psychological pricing strategy' to increase sales.
- a) Price is one element of the marketing mix. Identify **two** other elements. [2]
 - b) What is meant by 'price-elastic demand'? [2]
 - c) Identify and explain **two** reasons why demand for cereals might be price elastic. [4]
 - d) Identify and explain **two** factors A & B should take into account when deciding which pricing strategy to use. [6]
 - e) Do you think changing to psychological pricing strategy will increase sales? Justify your answer. [6]
- 2 X & Z have recently designed a new game for the Microsoft Xbox®, a games console. People in many different countries have been waiting for this new game and they are willing to pay a high price to be some of the first people to play the game. 'The business can get back some of the development costs of the new game by using price skimming,' says the Marketing Manager. X & Z have a product range of 20 games, some of which were developed several years ago.
- a) What is meant by 'price skimming'? [2]
 - b) Identify **two** factors that affect the price of the new game for the Xbox®. [2]
 - c) Identify and explain **two** reasons why X & Z might use price skimming for their new game. [4]
 - d) Identify and explain **two** other pricing strategies X & Z could use. [6]
 - e) Do you think that just using the price skimming strategy for all the games produced by X & Z is the best decision to take? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- the role of pricing decisions in the marketing mix
- about the different methods of pricing a business can use and their benefits and limitations
- how to select a suitable pricing strategy for a particular business situation/objective
- the difference between price-elastic demand and price-inelastic demand
- about the importance of price elasticity of demand in pricing decisions.

NOW – test your understanding with the revision questions on the CD-ROM.

The marketing mix: promotion and technology in marketing

This chapter will explain:

- the role of promotion decisions in the marketing mix
- the aims of promotion
- different forms of promotion and how they influence sales
- when to use different forms of promotion
- the importance of the marketing budget in making promotion decisions
- how technology influences the marketing mix.

The role of promotion decisions in the marketing mix

Promotion gives the consumer information about the rest of the marketing mix – without it, consumers would not know about the product, the price it sells for or the place where the product is sold. It is often thought that promotion is just about advertising the product, but it includes several different types of promotion as well as advertising.

It is difficult to think of products that are not advertised and promoted. Most products are produced for the mass market and therefore need advertising and promoting. Producer goods are often sold directly by sales representatives visiting businesses but even these products are advertised in trade magazines, or leaflets are sent out to businesses informing them about the product.

Promotion is essential when a brand image is being created for a product.

Promotion as part of the marketing mix includes:

- *advertisements* – this involves ‘above-the-line’ promotions. These can take different forms, such as advertising on television, via the internet, in newspapers and magazines and other forms of advertising media
- *sales promotion* – this involves ‘below-the-line’ promotions. These are often used for short periods of time in order to reinforce the above-the-line promotions. Examples include giving money-off coupons, free gifts, or product placements in television programmes or newly released films.

The aims of promotion

As you can see, promotion includes many activities that are undertaken by businesses. They all have one thing in common – their purpose, which is to raise awareness of the firm’s products and encourage consumers to make a purchase. The aims are summarised in the diagram below.



Advertising

Different types of advertising

Advertising can be either **informative** or **persuasive** or have elements of both. '1 million' by Paco Rabanne is an expensive aftershave. It is not sold by telling people all about what it will do for the skin. The advertising is meant to make consumers think that when wearing the aftershave they will smell nice to the opposite sex and look more attractive. The adverts for the aftershave used in magazines show a picture of an attractive man, which is meant to persuade the readers to buy the aftershave so that they will be attractive like the man in the advert.



Would consumers buy a laptop that was shown in adverts as being used by an attractive person, but with no technical information provided? Probably not. When buying a laptop, consumers want to know what speed it will run at and what memory it has. They want information about the product and its price.



Definitions to learn

Informative advertising is where the emphasis of advertising or sales promotion is to give full information about the product.

Persuasive advertising is advertising or promotion which is trying to persuade the consumer that they really need the product and should buy it.

The advertising process

When planning an advertising campaign the business will need to go through the steps shown in the diagram below.

1 Set objectives

The business will have to decide the purpose of the advertising. Is it to capture a new market? Is it to increase market share? Is it to improve the image of the company? Is it to create or improve a brand image?

2 Decide the advertising budget

The business will need to decide how much to spend on advertising. This is a difficult task, too much and money is wasted, too little and the advertising will not be effective. One way, used most often, is to predict how much sales will be in the future and then spend a certain percentage of the predicted sales on advertising the product. This way the expense of advertising is related to the revenue brought in by sales of the product. The percentage used is usually between 2 and 10 per cent of sales revenue. Sometimes the budget will be set by how much competitors are spending on their advertising. Or sometimes it is simply what the business can afford to spend. This is particularly true of small businesses.

3 Create an advertising campaign

The business will need to decide what sort of advertising campaign to run. For example, will the adverts be to attract young people? The target audience (the people who the advertisers think might buy the product) and the purpose of the advertising must be kept in mind when creating the campaign.

4 Select the media to use

The business will need to decide which is the best type of advertising media to use. The target audience will determine the most suitable forms of media to use to make sure that the adverts are seen by the people intended. The business will also need to decide how often the adverts will appear in order to make sure the target audience sees them and is encouraged to buy the product. The type of media selected has to be cost effective. It is pointless spending a lot of money on television advertising when the business is not trying to reach a mass audience, but only wants to target bicycle riders. It would be more cost effective to advertise in bicycle magazines which would be cheaper and seen by the people who are the potential customers and no one else.


5 Evaluate the effectiveness of the campaign

The business needs to see if sales have increased as a result of the advertising campaign or see if the product's brand image has improved, i.e. has the advertising campaign met its objective?





The following table shows types of advertising media that businesses can use, together with the advantages and disadvantages of each and some examples of when they may be used.

Definitions to learn



The **target audience** refers to people who are potential buyers of a product or service.

| Advertising media | Advantages | Disadvantages | Examples of suitable products/services to advertise using this method |
|---|---|--|--|
| Television  | <ul style="list-style-type: none"> • The advert will go out to millions of people. • The product can be shown in a very favourable way, making it look attractive. • It reaches the biggest number of consumers and can reach a target audience by advertising at times when the programmes the potential buyers are likely to be watching are being shown. | <ul style="list-style-type: none"> • Very expensive form of advertising. | <ul style="list-style-type: none"> • Food products and drinks that are bought by most people. • Cars that are bought by a large number of customers. • Household products, e.g. soap powder, that are bought by most of the population. |
| Radio  | <ul style="list-style-type: none"> • Cheaper than television. • Usually reaches a large audience. • Often uses a memorable song or tune so that the advert will be remembered. | <ul style="list-style-type: none"> • Cannot put across a visual message. • Quite expensive relative to other methods of advertising. • The advert needs to be remembered, the customer cannot look back at a hard copy of the advert. • Not as wide an audience as television. | <ul style="list-style-type: none"> • Local services or events are often advertised on the radio on local channels, e.g. local shops, car showrooms. |
| Newspapers (national or local)  | <ul style="list-style-type: none"> • National newspapers are often bought by particular customers and therefore the newspaper in which the advertisement is placed can be selected to target a particular group of people. • A large number of people will purchase and read national newspapers. • Local newspapers are relatively cheap to place adverts in and are a cost-effective way to advertise. • Adverts are permanent and can be cut out and kept. • A lot of information can be put in the advert. | <ul style="list-style-type: none"> • Newspaper adverts are often only in black and white and are therefore not very eye-catching. Not as attention grabbing as television adverts and may not be noticed by the reader, especially if the advert is small. | <ul style="list-style-type: none"> • Local products, local events in local newspapers. • Cars, banks in national newspapers. |

(continued)

| Advertising media | Advantages | Disadvantages | Examples of suitable products/services to advertise using this method |
|---|--|---|--|
| <p>Magazines</p>  | <ul style="list-style-type: none"> Magazines are read by a specific type of person or business, e.g. bicycle enthusiasts reads bicycle magazines – very effective way to reach the target population if there are specialist magazines which cover a particular activity. Magazine adverts are in colour and therefore can look more attractive. | <ul style="list-style-type: none"> Magazines are often only published once a month or once a week. Advertising in magazines is relatively more expensive than newspapers. | <ul style="list-style-type: none"> Perfume in specialist magazines for women. Golf equipment in golf magazines. Medical equipment in professional journals. |
| <p>Posters/billboards</p>  | <ul style="list-style-type: none"> They are permanent. Relatively cheap. They are potentially seen by everyone who passes them. | <ul style="list-style-type: none"> Can easily be missed as people go past them. No detailed information can be included in the advert. | <ul style="list-style-type: none"> Local events. Products purchased by a large section of the population as posters are seen by everyone passing the advertisement. |
| <p>Cinemas, DVD and blu-ray discs</p>  | <ul style="list-style-type: none"> Can give visual image of the product and show the product in a positive way. Relatively low cost. Can be very effective if your target audience go to see particular films. | <ul style="list-style-type: none"> Seen by only a limited number of people who go to watch the film or buy the DVD or Blu-ray disc. | <ul style="list-style-type: none"> Coca-Cola when a film for teenagers is showing. |
| <p>Leaflets</p>  | <ul style="list-style-type: none"> Cheap method of advertising. Given out in the street to a wide range of people. Direct mail – could be delivered door to door or mailed to a large number of people. Sometimes contain a money-off voucher to encourage the reader to keep the advert. The adverts are permanent and can be kept for future reference. | <ul style="list-style-type: none"> May not be read. Direct mail also called 'junk mail' can be annoying and puts customers off buying the product. | <ul style="list-style-type: none"> Leaflets are often used to advertise local events. Could be given out to promote retail outlets and may contain a money-off voucher on the leaflet. |

(continued)

| Advertising media | Advantages | Disadvantages | Examples of suitable products/services to advertise using this method |
|---|---|--|---|
| Internet (see later section on technology and advertising)  | <ul style="list-style-type: none"> • A large amount of information can be placed on a website, which can be seen by a vast number of people at home and abroad. • Orders can be made instantly via the website. • Direct mail sent via email is cheap. | <ul style="list-style-type: none"> • Internet searches may not highlight the website and it could be missed. • In some countries internet access is limited. • There is a lot of competition from other websites. • Security issues may discourage customers from buying online. | <ul style="list-style-type: none"> • Products that customers are already familiar with, e.g. CDs, electrical goods, books, fashion clothes. • Services such as train information and ticketing, and insurance, are also suitable. |
| Other forms of publicity  | <ul style="list-style-type: none"> • Very cheap form of advertising, e.g. on delivery vehicles, T-shirts and on the sides of bags from shops. | <ul style="list-style-type: none"> • May not be seen by customers in the target market. | <ul style="list-style-type: none"> • Shops use the bags given out with purchases to advertise their name. • Coca-Cola uses neon signs to advertise its name. |
| Product placement (when branded goods and services are featured in television programmes, movies or music videos) | <ul style="list-style-type: none"> • Products are associated with the image in the programme or movie. • Can target a specific audience who view the programme, movie or music video. | <ul style="list-style-type: none"> • Can be expensive to pay for the placement of the product in the programme. • May have negative effects on the consumer if the image is not attractive to them. | <ul style="list-style-type: none"> • Expensive, high-powered cars used in James Bond films that portray excitement and speed. |

Case study example

ING



ING is a global institution of Dutch origin, offering banking, investments, life insurance and retirement services. As they are a large international business, they can afford a large marketing budget. It uses advertising on the internet, television, magazines, billboards, product placement and sponsorship.

Activity 14.1

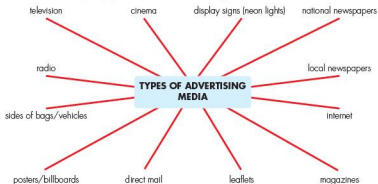
Read the case study above.

Do you think ING's current methods of advertising are the best methods to use or should it change them? Explain your answer.

Tips for success

Make sure you can select suitable types of advertising for particular products and explain why they are suitable.

Revision summary: types of advertising media



Activity 14.2

a) Choose ten products which you and your friends buy regularly. Collect examples of the advertising and write down where the products are advertised. Copy out the table below and fill in the blanks when you have all your examples.

| Product | TV | Radio | News-papers | Magazines | Cinemas | Posters/ billboards | Leaflets | Internet | Other |
|---------|----|-------|-------------|-----------|---------|------------------------|----------|----------|-------|
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After you have filled it in:

- b) What can you observe from your completed table?
- c) Do the places where the adverts are found suggest a particular target audience for the products?
- d) Is the target population a very large number of people or a relatively small number of people?
- e) Do the places suggest the product is only sold locally or also nationally?
- f) Are these findings what you expected? Explain your answer.

Activity 14.3

For each of the following products, decide on the best advertising media to use. Explain your choice in each case.

- Nike, who produce an established brand of sports shoes, which is sold to teenagers as a leisure shoe, want to become more competitive with rival companies. This product is sold in many areas of the country.
- A new bicycle has been produced which is suitable for using over rough ground and for cycling up mountains.
- A new computer game has been developed.
- A new restaurant in a small town has opened.
- A famous brand of fizzy soft drink wants to expand its sales.
- A local town is holding a festival.

Sales promotion

Different types of sales promotion

Promotion is used to support advertising and encourage new or existing consumers to buy the product. This is sometimes known as ‘below-the-line’ advertising.

Sales promotion is used in the short term to give a boost to sales, but it is not used over long periods of time. An example of this might be when a new chocolate bar has been introduced on to the market and is being advertised on television. In the shops where the chocolate bars are to be sold, free samples may be given out to encourage the customers to try the new chocolate bar and, if they like it, to become regular buyers.

There are several different types of sales promotion that can be used by businesses.

Price reductions



Examples include reduced prices in shops at specific times of the year and money-off coupons to be used when a product is next purchased. These can be linked to loyalty cards when customers are sent money-off coupons after they have spent a certain amount of money at the shop. (Loyalty cards were discussed in Chapter 10.) Money-off coupons are sometimes found on the bottom of leaflets, in newspapers or on the packet of the product itself, for example, ‘\$1.00 off your next packet’. This encourages the consumer to try the product and hopefully they will become a regular customer.

Definitions to learn

Sales promotion – incentives such as special offers or special deals aimed at consumers to achieve short-term increases in sales.

Gifts



Sometimes small gifts are placed in the packaging of a product to encourage the consumer to buy it. This is often used with products like breakfast cereals and the gifts are usually aimed at children. Sometimes coupons are put on the back of packets and have to be cut out and collected. When a specific number have been gathered they can be exchanged for a gift, such as a book. If the item on offer is more expensive, the coupons may be exchanged for the item but a small additional charge may also have to be paid. Collecting coupons requires several packets of the product to be purchased before the gift can be claimed and so several packets of the product will be sold. The aim is that the customer may continue buying the product even after the promotion has ended.

BOGOF



This is where multiple purchases are encouraged (for example, 'Buy one and get one free').

Competitions



The packaging of a product may include an entry form which allows the customer to enter a competition. The prize is often an expensive item, such as a car. This again obviously encourages the consumer to buy the product.

Point-of-sale displays and demonstrations



Point-of-sale is the place where the product is being sold – usually a shop.

In the shop, there may be a special display of the product. With some products it can be an advantage to show how they should be used and therefore a demonstration in the shop can be a good way of encouraging customers to buy.

After-sales service



With expensive products, like cars or computers, providing an after-sales service can be a way of encouraging the customer to buy. They can be reassured that, if the product goes wrong in the first few weeks or months after they have bought it, they will be able to take it back and get it repaired with no additional charge to themselves. This may make the customer buy from a shop that offers an after-sales service rather than from somewhere that does not.

Tips for success

Make sure you can select a suitable sales promotion for particular products and explain why it is suitable.

Free samples



This is most commonly used with products like food, shampoo and cleaning products. A free sample can be handed out in the shop to encourage the customer to try the product and hopefully buy it. Free samples can be delivered to people's houses – although this would not be to every person's house, just the neighbourhoods where the business thinks people will buy the product. Free samples can also be given away with other products. For example, new washing machines often contain a free sample of washing powder.

Revision summary: types of sales promotion



The advantages of sales promotion

- It can promote sales at times in the year when sales are traditionally low (off-season purchases).
- It encourages new customers to try an existing product.
- It encourages consumers to try a new product.
- It encourages existing customers to buy a product more often or in greater quantities.
- It encourages customers to buy your product instead of a competing brand.

Activity 14.4

Choose ten products which you and your friends buy regularly. Collect examples of promotions that have been used for these products and explain why these methods of promotion were being used.

Activity 14.5

For each of the following five products decide the best method of promotion to use. Explain your choice in each case.

- A new magazine aimed at teenage boys.
- A new type of pen which is very comfortable to use and does not smudge.
- A company making a famous brand of football boots wants to expand sales.
- A new fast food takeaway opens in a small town.
- A soft toy has been invented that changes colour when hugged and can be dressed in different clothes which also change colour when warmed.

Case study example



Mattel sell a range of Barbie dolls for young children. They are sold through toy shops, where a special stand is provided for the shop to display the dolls so that they are easily seen by customers. A new Chinese Barbie doll in the range has just been introduced. To show children the new doll and its range of clothes, a representative of the company is visiting toy shops to demonstrate the doll and its accessories. Also, with each purchase of the new doll there is a chance to enter a prize draw – the first prize is a trip to Disneyland.

Activity 14.6

Read the case study above.

Do you think all these ways to promote the new range of Barbie dolls will be effective? Explain your answer.

Definitions to learn

A **marketing budget** is a financial plan for the marketing of a product or product range for a specified period of time.

The importance of the marketing budget

When deciding which type of promotion (advertising and sales promotion methods) will be most suitable to use for a particular product then the marketing budget is perhaps the most important factor in making promotion decisions.

So, the size of the **marketing budget** is crucial. It specifies how much money is available to market the product or range, so that the Marketing department know how much they may spend. If the business cannot afford a very large budget, this will limit the places where the business can advertise. For instance, if the budget is small, television advertising will not be possible, and the number of times adverts appear in a magazine could be higher if the budget was larger.

The need for cost effectiveness in spending the marketing budget is very important. A business will need to compare the cost of advertising with the increase in expected sales. It is not good to spend large amounts of money on an advertising campaign if there is only a small increase in sales.

Small firms will find it very difficult to compete with larger ones because of the large marketing budget available to them.

Which type of promotion should be used?

The following points also need to be considered when deciding on the type of promotion to use:

Tips for success

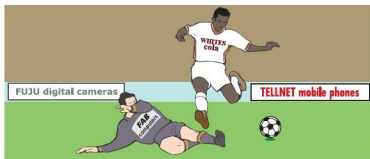
Remember that advertising does not necessarily increase sales and profits. A lot of money can be spent on advertising and not be effective. Advertising may increase sales, but if prices have been reduced and advertising expenditure increased then profits may not increase.

- *The stage of the product life cycle that has been reached.* Read Chapter 12, pages 164–166, to see which stages of the life cycle require different methods of promotion. If the product is new and has just been launched, the advertising may be more informative, but if the product is well established and is at maturity then the advertising may be persuasive.
- *The nature of the product itself.* If the product is a producer good, the type of promotion that would be used when promoting the product to other producers will be quite different to the methods used with consumer goods. For example, money-off coupons would not be suitable, but discounts when goods are purchased in bulk would be appropriate. Businesses would not be influenced by collecting money-off coupons, but they will buy in large quantities and will be influenced by a discount. A product sold to other businesses, for example, a machine to wrap perfume, will not be advertised in the same way as the perfume itself, which will be bought by consumers. The advertising for the machine will be informative, while the advertising for the perfume will be persuasive.
- *The cultural issues involved in international marketing.* If the product is to be sold abroad then different types of promotion may be appropriate. The advertising media used will be dependent on factors such as the number of televisions owned, literacy of the population, availability of radio and cinema. It is no use advertising in a national newspaper if most of the population do not read or cannot afford a newspaper. Free samples, competitions, special offers, etc. will also have to be suitable for the culture of the population. In some countries it might not be usual to enter competitions and therefore this promotional route would not act as an attraction to buy the product. The business might need to consider the types of promotion in terms of what is acceptable to people in the countries where the product is being sold. For instance, the use of women in adverts or the promotion of alcohol would not be allowed in some parts of the world.

- *The nature of the target market* – whether it is local, national or international and its size – a local market will require different media to a national one or an international one. Is the product a specialist product such as water skis or is it one that is sold to the majority of the population such as cola?

Public relations/sponsorship

This is concerned with promoting a good image for the company and/or its products. Public relations can take many forms, from sponsoring events such as football matches, to publicity stunts where employees, or owners of the company, take part in a sponsored activity for a good cause, or to raise awareness.



Another example is where companies donate some of their products to charity – for relief when there has been a natural disaster, or food for victims of a famine.

All these types of activity raise the public's awareness of the company and its products, and increase the likelihood of their choosing its products over its competitors.

How technology influences the marketing mix

New technology is becoming integrated into marketing decisions. It presents new opportunities for businesses to market their products and services and it means there are frequent changes to all four elements of the marketing mix.

The **product** part of the marketing mix may be changed to respond to new technology. For example, new features added to mobile (cell) phones. Social networking sites such as Facebook are changing the way businesses reach their potential customers. Twitter[®], pop-ups, sponsored links, paying search engines to put your websites at the top of searches, own reviews on websites, blogs, to name

but a few are all new ways businesses are using to **promote** their business or its products on the internet. The internet allows businesses to gather information about customer purchasing habits which means dynamic **pricing** can be used to raise revenue. And finally, the internet has facilitated the widespread use of online purchasing – e-commerce (**place** is covered in Chapter 15).



Activity 14.7

Research the internet to find different ways businesses advertise on the internet.

Write down a list of at least ten different businesses or products and how they are being advertised. (Try to include a variety of methods they are using.)
Include screen shots of the adverts if possible.

There are a number of benefits to a business of advertising on social networking sites such as Facebook:

- targets specific demographic group
- guarantees target customers see advert when they go onto Facebook
- speed in response to market changes – information can be updated regularly
- cheap to use – it has no costs if just placing advertisements
- reaches groups that are difficult to reach any other way.

However, there are disadvantages too:

- can alienate customers if they find the adverts annoying
- have to pay for advertising if using pop-ups
- lack of control of advertising if used by others
- may be altered or used in a bad way and forwarded on to other users giving the business bad publicity.

If a business advertises on its own website it will enjoy the following benefits:

- no extra cost if own website is already set up
- control of advertising as it is on your own site
- can change adverts quickly and update pictures/prices, etc.
- interactive adverts can make the adverts more attractive than those in other forms of advertising media such as magazines and posters
- can provide more information in adverts and link to other pages with further information and pictures.

However, there are disadvantages too:

- potential customers may not see the website as the page may come up in a long list of pages when using a search engine such as Google
- relies on customers finding the website
- design costs of the website may be high.

Activity 14.8

Look at the lists above and produce a similar list of advantages and disadvantages for a business that is using the following to promote its products or services:

- tweets
- blogs
- specialised apps to be downloaded for the business/brand of products
- text messages.

Activity 14.9

For each of the following products, choose three different ways to advertise them using the Internet. Explain the advantages and disadvantages for each way. Then choose which you think is the best way. Justify your choice and explain why it is better than the other two ways.

- Reebok, which produces an established brand of sports shoes that is sold to teenagers as a leisure shoe, wants to increase its market share.
- RAOUL makes smart casual outfits and crisp business shirts and jackets which are sold in boutiques in fashionable malls throughout Singapore.
- A new restaurant has opened in your nearest city centre.
- Your school is holding a charity fundraising event.

A company website

International business in focus: Justin Bieber

Justin Drew Bieber was born 1 March 1994 and is a Canadian pop/R&B singer, songwriter and actor. He was discovered in 2008 by Scooter Braun, who came across Bieber's videos on YouTube and later became his manager. Justin is very popular, particularly amongst younger age groups. He is preparing to go on a world tour. The tour will involve concerts in many countries around the world and it is predicted that tickets for his concerts will be sold out very quickly.

Discussion points

- Discuss the best way for the tour dates of the concerts to be advertised.
- Choose another singer and consider what other promotions could be used to promote them and their music.

Exam-style questions – Paper 1

- 1 TP manufactures expensive women's shoes. It sells its range of shoes through shops which sell made-to-measure designer clothes for women. 'We need to be clear of who our target market is' says the Marketing Manager.
- What is meant by 'target market'? [2]
 - Identify **two** examples of advertising TP could use. [2]
 - Identify and explain **two** reasons why it is important for TP to know the target market when deciding how to advertise the shoes. [4]
 - Identify and explain **two** possible aims for TP of using promotion. [6]
 - Do you think advertising is needed for their range of shoes? Justify your answer. [6]
- 2 FK is a partnership and it manufactures drinking glasses. Customers pay FK to put their own designs or messages on the outside of the glass. These are often given as gifts at weddings, births or other special celebrations. FK is thinking of starting to also manufacture plain glasses for everyday use. These glasses would be sold at supermarkets, but the specially designed glasses are ordered on the internet. FK only have a small advertising budget and so the owners will have to think carefully about where will be the best place to advertise the plain glasses.
- What is meant by an 'advertising budget'? [2]
 - Identify **two** places, other than the Internet, where FK could advertise its glasses. [2]
 - Identify and explain **two** reasons for promoting the glasses. [4]
 - Identify and explain **two** methods of sales promotion FK could use to promote the plain glasses sold in supermarkets. [6]
 - Do you think the promotion of the plain glasses should be different to the promotion used for the specially designed glasses? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- about the role of promotion decisions in the marketing mix
- about the aims of promotion
- to select appropriate types of sales promotion for different products/business objectives
- to select appropriate types of advertising for different products/business
- the importance of the marketing budget in making promotion decisions
- how technology influences promotion decisions.

NOW – test your understanding with the revision questions on the CD-ROM.

This chapter will explain:

- the role of place decisions in the marketing mix
- the advantages and disadvantages of distribution channels
- e-commerce and its threats and opportunities to business and consumers.

The role of place decisions in the marketing mix

After deciding on the product and right price, the business has to get the product to the consumer. The product or service has to be available where and when customers want to buy. Where consumers can buy the product will affect how well it will sell. Think of your local shop where you buy food. Would expensive luxury chocolates sell well? If many of the customers who use the shop are on low incomes then not many chocolates will be sold. If the product is not available where customers want to buy it, and they have to go searching in different shops, then they may give up and buy a competitor's product. It is very easy for a business to get the place wrong and therefore lose sales, or even fail altogether.

How consumers get to know about the product through promotion is important, but they must also be able to buy the products easily.

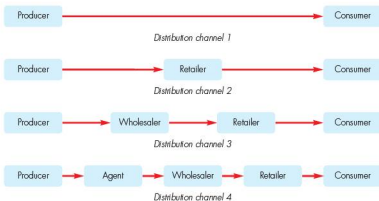
Distribution channels

Businesses have to decide where to sell their products. They also have to decide how to get the product to the consumer, that is, what **distribution channel** to use.

The distribution channel can vary – from being directly to the consumer to being via intermediary channels. The diagram below summarises the main distribution channels that are used.

Definitions to learn**A distribution channel**

is the means by which a product is passed from the place of production to the customer or retailer.



The main distribution channels

Distribution channel 1

Advantages

- This distribution channel is very simple. It involves manufacturers selling their products directly to the consumer.
- It is suitable for products, such as certain types of agricultural products, which are sometimes sold straight from the farm.
- There is a lower price if sold direct to customer – cuts out wholesaler/retailer.
- Products can be sold by mail order catalogue or via the internet.

Disadvantages

- This is usually impractical for most products because the consumers probably do not live near to the factory and could not go there to buy the products.
- This method may not be suitable for products which cannot easily be sent by post.
- It may be very expensive to send the products by post and therefore it will not be cost effective.

This channel is also common when selling directly from one manufacturer to another manufacturer. For example, car components are sold directly to the car producer.

Distribution channel 2

The second distribution channel is where the producer sells directly to retail outlets and then they sell the product to the consumer. This is most common where the retailer is large, such as a large supermarket, or when the products are expensive, such as furniture or jewellery.

Advantages

- Producer sells large quantities to retailers.
- Reduced distribution costs compared to distribution channel 1.

Disadvantage

- No direct contact with customers.

Distribution channel 3

This distribution channel involves using a wholesaler, who performs the function of breaking bulk.

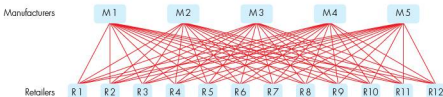
Breaking bulk is where wholesalers buy products from manufacturers in large quantities and then divide up the stock into much smaller quantities for retailers to buy.

Advantages

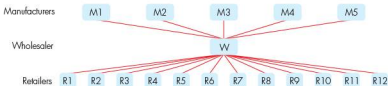
- Wholesaler saves storage space for small retailer and reduces storage costs.
- Small retailers can purchase products in small quantities from wholesaler because they have a relatively short 'shelf life' before they deteriorate.
- May give credit to customers so they can take the goods straight away and pay at a later date.
- Wholesaler may deliver to the small retailer thus saving on transport costs.
- Wholesaler can give advice to small retailers about what is selling well. They can also advise the manufacturer what is selling well.

Disadvantages

- May be more expensive for the small shop to buy from a wholesaler than if they bought straight from the manufacturer.
- Wholesaler may not have the full range of products to sell.
- Takes longer for fresh produce to reach the shops and so it may not be as good quality.
- Wholesaler may be a long way from the small shops.



Without a wholesaler, a manufacturer has to process many orders from retailers



With a wholesaler, a manufacturer has less paperwork

Distribution channel 4

When products are exported, the manufacturer sometimes uses an **agent** in the other country. The agent sells the products on behalf of the manufacturer. This can allow the manufacturer to have some control over the way the product is sold to consumers. The agent will either put an additional amount on the price to cover their expenses or will receive a commission on sales.

Advantages

- Manufacturer may not know the best way to sell the product in other markets.
- Agents will be aware of local conditions and will be in the best position to select the most effective places in which to sell.

Disadvantages

- Less control over the way the product is sold to customers.

Case study example

Unilever (M) Holdings Snd Bhd manufacture ice cream and sorbets. It is located in Malaysia. It is famous for its quality ice cream and sorbets. The company sells ice cream and sorbets directly to local shops because they sell to tourists. Unilever (M) Holdings Snd Bhd also sells its ice cream to wholesalers who sell to small shops in other towns and cities. Very large retailers, for example supermarkets, buy the ice cream and sorbets in bulk and purchase it directly from Unilever (M) Holdings Snd Bhd. A variety of channels of distribution are used by the company, depending on the customer and the quantity of ice cream and sorbets purchased.

Definitions to learn

An **agent** is an independent person or business that is appointed to deal with the sales and distribution of a product or range of products.

Methods of distribution

The methods of distribution used can include the following:

| Method of distribution | Description |
|-------------------------|--|
| Department stores | A large store, usually in the centre of towns or cities, that sells a wide variety of products from a wide range of suppliers. |
| Chain stores | Two or more stores which have the same name and have the same characteristics. |
| Discount stores | Retail stores offering a wide range of products, many branded products, at discount prices. Often the product ranges are of similar types of products, e.g. electrical goods. |
| Superstores | New very large out-of-town stores which sell a wide range of products. |
| Supermarkets | Retail grocery stores with dairy produce, fresh meat, packaged food and non-food departments. |
| Direct sales | Products are sold directly from the manufacturer to the consumer (distribution channel 1). |
| Mail order | Customers look through a catalogue or magazine and order via the post. Orders can also often be placed by telephone or internet. |
| Internet/ e-commerce | Instead of looking at a catalogue, consumers view the goods on the business's website and then order on the internet or possibly by telephone or mail. Business can sell through other specialist websites such as eBay and Alibaba.com. |

Definitions to learn

e-commerce is the buying and selling of goods and services using computer systems linked to the internet.

Tips for success

Make sure you can apply the benefits and threats of e-commerce to a particular business.

e-commerce

When was the last time you purchased a product by computer or mobile phone linked to the internet? Some people will answer 'I never have' to this question but others will say 'five minutes ago!' The growth of internet selling has been incredible in recent years. Online retailing only started in the US in 1992 – yet by 2012 internet sales in the US alone were US\$ 217 billion!

Consider these two statements by different marketing managers.

- Manager A: 'Since my company introduced a new website which allows e-commerce, sales have increased by 55 per cent including sales to countries we have never sold to before. We are now thinking about closing some of our retail shops.'
- Manager B: 'My company sells handmade suits for men and women. We offer a personal service and customers visit us several times during the making of their suit to check for size and style. We use the internet only for gaining market research and dealing with suppliers.'

How can both managers be so convinced their company has the correct approach to e-commerce? The answer is ... they could both be right! Not every product or every service will be successfully sold by e-commerce. This means that we need to consider the different impact that the internet and e-commerce can have on businesses and consumers.

| Opportunities of e-commerce to business | Opportunities of e-commerce to consumers |
|---|---|
| Websites can be used to promote the company and its products worldwide much more cheaply than other forms of marketing, e.g. setting up shops in many countries. | No need to leave the house to 'go shopping' and this convenience is a major factor explaining the growth of e-commerce. |
| Orders can be taken over the computer and sent directly to company warehouse for dispatch. | Comparisons between prices and products or services offered can be easily made by surfing from one website to another – or using 'price comparison' websites. |
| Consumers might be encouraged to purchase more products than they intended by attractive and easy to follow websites – e.g. giving links to other products that could be bought with the original purchase. | Payment by credit or debit card is very easy. |
| Businesses can also easily make online purchases of supplies and materials from other businesses – this is called business-to-business (or B2B) e-commerce. | Consumers can now easily access products and services from businesses located abroad – this would be very difficult or expensive without e-commerce. Consumers can buy some products for prices much lower than they would be without the competition of e-commerce, e.g. books, music and insurance policies. |

| Threats of e-commerce to business | Threats of e-commerce to consumers |
|---|---|
| With so many businesses now offering e-commerce websites, competition between businesses is very high. If a business is charging higher prices, consumers can easily find an alternative supplier. | Consumers need access to the internet! It is still the case that in many countries internet access, especially for low-income consumers, is very poor. |
| Website design must be very clear, attractive and easy to operate. Website designs can be expensive – and will often need to be updated and this will lead to further costs. | Computer systems failures or weak internet connections can result in frustrated consumers who cannot access websites and make their purchases. |
| Transport costs per product sold are likely to be higher than selling through traditional shops. Each item must be packaged and delivered separately. Should consumers be asked to pay these costs? Or will this make the business uncompetitive? | Products cannot be seen, touched or tried on (clothing, for example) and sending products back because they are unsuitable ('returns') is often inconvenient. |
| There is no face-to-face contact with consumers, which can provide very useful market research feedback. | There is no face-to-face contact with sales staff so it is difficult to find out more information about the goods and services being sold than that which is provided on the website. |
| Consumers in most countries have the legal right to reject goods bought through e-commerce because they have not seen, touched or worn the actual good. 'Returns' can add to business costs. | Many consumers are concerned about identity theft or fraudulent use of credit cards if they buy goods online. Security systems are improving but there are still some risks. |
| Although fewer shops may be needed, a large warehouse and efficient stock control system will be essential to meet consumers' orders accurately and efficiently. | |
| e-commerce is not suitable for businesses that sell personal services such as hairdressing or products for which consumers expect personal face-to-face service. | |

Revision summary: e-commerce



Activity 15.1

Choose six different products that you or your family buy and find out what distribution channels are used to get the products from the manufacturer to you, the customer. Are the distribution channels used the ones you would expect? Explain your answer.

Tips for success

Make sure you can select suitable distribution channels for a particular business or its products.

Case study example

You have been asked by a manufacturer of children's toys whether they should use a wholesaler to sell their products. They originally manufactured just a few different types of toys and sold them to a small number of large retailers. They have expanded and are now selling many different types of toys to a large number of small retailers.

Activity 15.2

Read the case study above.

Write to the company advising them why you think it might be advantageous to use a wholesaler. They need persuading that a wholesaler will be beneficial, so give detailed explanation and examples to support your point of view.

Selecting the distribution channel to use

When deciding which distribution channel to use, manufacturers have to ask themselves a number of questions. This will help them to decide which channel will be the most successful for their products. These are the types of question that need to be answered.

- **What type of product is it?** Is it sold to other producers or to ordinary customers?
- **Is the product very technical?** If it is, it should be sold to the customer by someone with technical knowledge who can explain how it works and what it will do. Direct selling from the manufacturer will probably be selected in this case. An example might be an aeroplane engine.
- **How often is the product purchased?** If it is bought every day, it will need to be sold in many retail outlets. An example would be a product like newspapers which are purchased daily and are sold in many outlets. If they were not readily available, customers might not bother to buy them at all.
- **How expensive is the product?** Does it have an image of being expensive? If the product is marketed as being expensive and of high quality, it will probably be sold through only a limited number of outlets. These shops will be in expensive shopping areas. For example, if the product is an expensive watch, it is no good selling it in discount jewellery shops.
- **How perishable is the product?** If the product goes rotten quickly, such as fruit or bread, then it will need to be widely available in many shops so that it can be sold quickly.
- **Where are the customers located?** If most of the customers are located in cities, it is no good selling the product in only rural areas. If the customers are located in another country, then different retail routes might be appropriate. The internet might be used for online trading.
- **Where do the competitors sell their products?** The retail outlets that competitors use will need to be considered. Each manufacturer will probably sell their products in the same outlets as their competitors so that they can compete directly for customers.

Activity 15.3

Choose a distribution channel for each of the following products. Explain your choice in each case.

- a) Farm tractor.
- b) Children's clothes for export.
- c) Tins of peas.
- d) Made-to-measure suits.

Revision summary: factors affecting distribution channels



International business in focus: Alibaba.com

Alibaba.com was formed in 1999 in China. It provided a market place for small businesses to sell their products. It has become a trusted source for online shopping and is now available not only in China but also in the global market in countries such as India, Japan, Korea, Europe and the US. More and more businesses use this website to sell their products and it has encouraged an increasing number of customers to shop online.

Discussion points

- Why do think customers like to shop on this website?
- What disadvantages might there be to businesses that use the website?
- If more consumers buy online, what will this mean to businesses which currently don't sell their goods online?

Exam-style questions – Paper 1

- 1 D & D manufacture footballs. The footballs are sold to sports shops throughout the world. The distribution channels D & D uses are to sell its footballs direct to retailers in some countries and through an agent in other countries.
 - a) What is meant by the 'distribution channel'? [2]
 - b) Identify **two** other examples of products which might be sold directly to retailers rather than using a wholesaler. [2]
 - c) Identify and explain **two** reasons why 'place' is an important part of the marketing mix for D & D. [4]
 - d) Identify and explain **two** benefits to D & D of using an agent to distribute its products. [6]
 - e) Do you think D & D would be better selling through a wholesaler? Justify your answer. [6]
- 2 Pinkor is a retailer chain selling children's clothes in its many small shops. It buys most of its products from wholesalers. Rakesh, the owner, says 'I think we should start to sell on the internet'.
 - a) What is meant by a 'wholesaler'? [2]
 - b) Identify **two** disadvantages to Pinkor of using a wholesaler. [2]
 - c) Identify and explain **two** benefits to Rakesh of selling through several small shops rather than one large shop. [4]
 - d) Identify and explain **two** factors which affect which distribution channel Pinkor should use. [6]
 - e) Do you think Rakesh is right to want to sell on the internet? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- the role of place decisions in the marketing mix
- about the different distribution channels and the advantages and disadvantages of each distribution channel
- what is meant by e-commerce and the threats and opportunities it offers to businesses and consumers
- to select the most suitable distribution channel for a given product.

NOW – test your understanding with the revision questions on the CD-ROM.

This chapter will explain:

- marketing strategies and how to develop an appropriate marketing strategy in given circumstances
- the nature and impact of legal controls related to marketing
- the opportunities and problems of entering new markets abroad.

Definitions to learn

A **marketing strategy** is a plan to combine the right combination of the four elements of the marketing mix for a product or service to achieve a particular marketing objective(s).

Marketing strategy

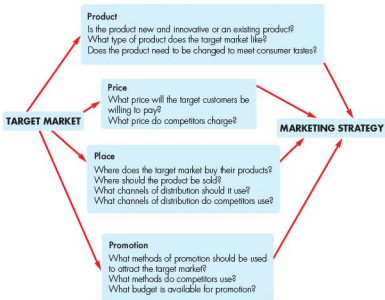
A **marketing strategy** is a plan to combine the right combination of the four elements of the marketing mix for a product or service to achieve a particular marketing objective(s).

The marketing strategy developed by a business will differ depending on the size of the market and the number and size of competitors. It will need to identify the marketing objectives of the business, the target market and the finance available (this is called the marketing budget).

The marketing objective could include:

- increasing sales of an existing product/service by selling to new markets or selling more to the existing market
- increasing sales of new product or service by improving an existing product (extension strategy – see Chapter 12) or a totally new innovative product
- increasing market share which will include increasing sales but also taking market share away from competitors
- maintaining market share if competition is increasing
- increasing sales in a niche market.

The different elements of the marketing mix are important in influencing consumer decisions when developing a marketing strategy aimed at a specific target market.



If the marketing strategy does not combine the four elements of the marketing mix correctly then the marketing objectives will not be achieved. For example:

- a product which meets customer needs and is priced at a suitable price which the target market is prepared to pay but will not actually buy the product if they do not know about it – that is, if the promotional methods are not suitable
- a product which does not meet the needs of the target market will not sell at any price.

Tips for success

Make sure you can develop a marketing strategy for a given product/service. The four elements of the marketing mix should all link together in order to be effective in attracting the target market to buy the product/service.

Case study: Nokia is losing market share to Samsung

For 14 years, Nokia was the world's biggest seller of mobile phones. It was overtaken by South Korea's Samsung in 2012 as the bestselling cell (mobile) phone in India and other emerging markets. Apple's iPhone® was seen as the main competitor but Nokia is also losing out in the basic phone market where it thought there were still years of strong growth in emerging markets.

In India, the world's second-biggest mobile phone market, Nokia's market share has halved from 62 per cent to 31 per cent of the total 183 million handsets sold. In China, the world's largest mobile phone market, its share of the market had fallen from 39 per cent in 2009 to 24 per cent in 2011.

In Africa its market share has also slipped to 51 per cent in 2011 from 62 per cent in 2009. It is surviving at the moment because of its superior distribution on the European continent but this will probably not last if it doesn't act quickly.

Nokia left the door wide open for Samsung and others by not delivering a full-touch-feature phone. The Koreans figured it out three years ago, yet Nokia still does not have a product, said Ben Wood, head of research at CCS Insight.

So even though Nokia had a good reputation, their phones were priced competitively, they were well promoted and sold in appropriate places for consumers, consumers still switched to other handsets, such as Samsung. Nokia mobile phones had failed to keep up with the latest technology and customer preferences. The 'product' part of the marketing mix wasn't right and so sales were falling even when the other three elements of the marketing mix were right.

Activity 16.1

Choose a product which you think will have a lot of sales in your country (this could be a new product or an existing product such as bottled water). Create a marketing strategy for this product by including answers to the following questions.

- a) Who is your target market? What are the characteristics of the consumers you think will buy your product? What is their market segment? Justify your answers.
- b) How does your product meet their needs? Why will consumers buy your product rather than a competitor's product? What is your product's unique selling point (USP) that makes it different to your competitors' products? Justify your answers.
- c) What price will this target market be willing to pay? What pricing strategy will you use? Justify your answers.
- d) Which methods of distribution (place) will you use and will these be suitable for your target market? Which methods of distribution do your competitors use? Justify your answers.
- e) What methods of promotion will you use? Remember you may have a limited budget/ amount of money to spend. Decide both where you will advertise and what promotional offers you might use. Justify your answers.
- f) Summarise by explaining why you think your new product will be successful.

Recommending and justifying a marketing strategy in given circumstances

As time goes by the marketing mix will need to be changed. This may be because there are new competitors, the product gets to a different stage of its product life cycle, consumer tastes change or the business wants to enter a different market.

Activity 16.2

Copy out the table onto a large sheet of paper. Then select the correct answer from the list below to fit each stage of the product life cycle.

The choices for Sales have already been filled in to get you started.

Note: You will need to study Chapters 13 and 14 before completing this activity.

| | Introduction | Growth | Maturity | Saturation | Decline |
|-----------------------|--------------------------------------|--------------------|----------------------------|---|--|
| Sales | Low sales because the product is new | Sales rise rapidly | Sales increase more slowly | Sales level off as market saturation is reached | Sales fall as new products become available or the product goes out of fashion |
| Pricing policy | | | | | |
| Promotion/advertising | | | | | |
| Likely profits/losses | | | | | |

Pricing policy

- Price skimming as few/no competitors.
- Penetration pricing by competitors as a few competing products are introduced, small reduction in your prices to compete with these products.
- Competitive pricing/promotional pricing as competition becomes intense.
- Price reductions to encourage sales as sales are falling, some competitors stop making the product.
- Competitive pricing/prices are reduced to compete with existing competitors, no new competitors enter the market.

Promotion/advertising

- Advertising reduced or may stop altogether as sales fall.
- Informative advertising as the product is new, free samples may be given out to get customers to try it.
- A lot of advertising to encourage brand loyalty and to compete with other very competitive products.
- A high, stable level of advertising may be promoting new improved versions of the original product.
- Informative advertising changed to persuasive advertising to encourage brand loyalty as sales start to rise rapidly.

Profits

- Loss made due to high development costs.
- Profits fall as sales fall.
- Profits fall as sales are static and prices have been reduced.
- Profits start to be made after development costs have been covered.
- Profits at their highest as sales growth is high.

Legal controls on marketing

Consumers can be easily misled. It is quite easy to sell to many consumers goods that are either unsuitable for the purpose intended or that fail to perform as the manufacturer claimed. This is not because consumers are stupid! It is because products are now so complicated and technical that it is very difficult for a consumer to know how good they are or how they are likely to work. Also, modern advertising can be so persuasive that nearly all of us could be sold products, even if they were later discovered to be of poor quality or not as good as the advert claimed. Consumers need protection against businesses which could, unfortunately, take advantage of the consumers' lack of knowledge and lack of accurate product information.

In the UK, the laws on consumer protection are typical of those existing in most countries and include some of the following forms of consumer protection.

Tips for success

Make sure you can explain why governments pass laws to protect consumers and what the laws mean for businesses when selling their goods or services.

Note: you will not be expected to name any particular laws in the Cambridge IGCSE® exam.

- **Weights and Measures.** Retailers and producers commit an offence if they sell underweight goods or if the weighing equipment they use is inaccurate.
- **Trade Descriptions.** It is illegal to give the consumer a deliberately misleading impression about a product. For example, it is illegal to state that a pair of trousers is made of wool, when they are made of cotton. Advertisements must therefore be truthful.
- **Sale of Goods.** It is illegal to sell products which have serious flaws or problems, that is they are not of a satisfactory quality; products which are not fit for the purpose intended by the consumer, for example if the consumer asks for a drill to make holes in walls and is sold one which is only suitable for wood; products which do not perform as described on the label or by the retailer, for example, if the label states 'These shoes are completely waterproof' and they leak the first time they are used!
- **Supply of Goods and Services Act.** This act does the same for services as the Sale of Goods Act does for products. A service has got to be provided with reasonable skill and care.
- It is illegal for misleading pricing claims such as '£40 off for this week only', when the product was also being sold for the same price the previous week. Most importantly, the law makes retailers and manufacturers liable – that is, responsible – for any damage which their faulty goods might cause. Anyone injured by faulty goods can take the supplier to court and ask for compensation.
- **The Distance Selling Regulations** allow customers a cooling-off period of seven working days – this means they can change their mind about purchasing the good or service. For goods, this starts from the day after the goods are delivered and for services, it's seven working days from the contract being agreed. These regulations apply to all transactions carried out over a distance as well as online transactions.

Here are some examples of consumer protection laws from Pakistan and South Africa.

Under Consumer Protection Act 2005, councils were set up in different regions in Pakistan, for example the Punjab Consumer Protection Council (PCPC). If consumers are not satisfied with a product or service they have purchased and the business has not dealt with the complaint in a satisfactory way then the consumer can register a complaint with the council. It will hear the case and then decide who is at fault. They have resolved hundreds of cases – for example, overcharging above normal rates, misleading statements by a shop keeper, warranty issues and misleading advertising.

Consumer Protection Act 2011, South Africa – here, consumers have up to six months to return faulty or unsafe goods and they have a choice between the supplier repairing or replacing these, or refunding you in full. This only applies to general wear and tear of your appliances and not gross negligence on your part. Also, if you

order online then the goods will have to be delivered at an agreed date, time and place. If not, you will be free to accept or cancel the agreement – it's your choice. Companies are also obliged to deliver goods that match the sample or description of the product. You have the right to examine your purchases before accepting them, and reject them if you're not happy.



It is illegal in many countries to sell items that do not live up to the claims made for them

Is all consumer protection a good idea? Most people would say that the consumer needs to be protected as much as possible. They believe that goods should be as safe and as suitable for the purpose intended as possible. However, some business managers believe that these laws add to the costs of making and selling products and this increases the prices in the shops. What is your view?

Activity 16.3

Here are three situations in which consumers might need some protection.

- 'These shoes are made of the finest leather.' In fact they are made of plastic.
- A consumer buys one kilogram of potatoes and re-weighs them at home. In fact, he has only 800 grams.
- A motorist asks for a tow rope 'strong enough for my trailer'. It breaks the first time he tries to use it.

Do you think the consumer needs some legal protection in these cases? For each example, identify which part of UK consumer protection laws have been broken by the business selling the goods.

Activity 16.4

Research the consumer protection laws in your country.

- What can a customer do if a product is faulty?
- What can a customer do if a product does not do what it is advertised to do?
- What other protection do the laws give customers?

Entering new markets abroad

Opportunities

These days a large number of businesses both produce and sell in many different countries. Why has there been this trend towards more globalisation of business?

- Growth potential of new markets in other countries. Countries in different parts of the world are now developing and seeing their population enjoying rising incomes.

This provides opportunities for entering new markets abroad.

- Home markets might be saturated and these new markets give the chance for higher sales.
- There is a wider choice of location to produce products and this encourages businesses to sell as well as produce in these countries. The business will have more information about these markets and be better placed to sell to them as well.
- Trade barriers have been lowered in many parts of the world making it easier and profitable to now enter these markets.

But there are problems when entering new markets abroad.

Tips for success

Make sure you can apply the opportunities and problems of entering new markets abroad to given circumstances.

- *Lack of knowledge* – the business may not be aware of competitors or the habits of consumers in these markets. For example where do most people do their shopping?
- *Cultural differences* – religion or culture may mean that some products won't sell in another market. For example, alcohol products will not be sold in many Middle Eastern countries.
- *Exchange rate changes* (see Chapter 28) – if the exchange rate is not very stable then exchange rate changes can mean the price of imported goods change and the products can become too expensive to sell in the new market.
- *Import restrictions* (see Chapter 26) – if there are tariffs or quotas on imported products then the prices of these products may be higher than domestically produced goods – reducing sales or profits or both.
- *Increased risk of non-payment* – methods of payment may be different in these new markets and it may be more difficult to be certain that payment for imported goods will be made.
- *Increased transport costs* – as products have to be transported over long distances then the costs of getting products to market will increase. However, there have been benefits from using containers to transport products and the container ships are getting larger and all this has led to reductions in transport costs.

Methods to overcome the problems of entering new markets abroad

- *Joint ventures* (see Chapter 4) – for example McDonald's, has a 50–50 joint venture with two Indian restaurant chains, Hardcastle restaurant and Connaught Plaza restaurants. This allows the business to gain important local knowledge so that culture and customs can be adapted to enable a more successful entry into the new market.
- *Licensing* – this is where the business gives permission for another firm in the new market being entered to produce the branded or 'patented' products under licence. This means the products do not have to be physically transported to the new market which saves time, transport costs and can get round trade restrictions.
- *International franchising* – this means that foreign franchises are used to operate a business's franchise abroad. For example Dunkin' Donuts which is a US-based baked goods and coffee franchise sold the franchise in the United Arab Emirates, which operates all the outlets. This means that again local knowledge is used to choose the best place to locate the Dunkin' Donuts outlets.
- *Localising existing brands* – there is a phrase 'thinking global – acting local' which is being used by several global businesses. It means that there is still a common brand image for the business but it has adapted to local tastes and culture therefore increasing sales.

Case study: McDonald's enters foreign markets



McDonald's have developed a special menu for their restaurants in India. The menu does not have beef burgers, but does have chicken burgers known as Chicken Maharaja-Macs and cheese burgers called Big Spicy Paneer on its menu. These products are suitable for the culture of this market as the majority of Indians are Hindu's so do not eat beef for religious reasons, but many do eat chicken, fish and cheese.

Activity 16.5

Read the case study above.

- Why did McDonald's change its menu in Indian restaurants?
- Why hasn't it done this in other countries?

International business in focus: Yeo's



Yeo's is a food business which was set up in 1900 in China, originally as a small shop making soy sauce. It moved to Singapore in the 1930s and started expanding. The business now makes a variety of food and cooking products including curry sauces, pastes, noodles and drinks. Today the company sells across the world including Singapore, Malaysia, Indonesia, Hong Kong, China, Canada and the US.

The Directors of Yeo's want to expand sales in the European market. It conducted 'sampling tours' throughout major UK, French and German Chinese supermarkets to raise awareness of their products. The company did not introduce the full range of its products into the European market.

Discussion points

- Why do you think Yeo's conducted 'sampling tours' across European countries?
- Why did Yeo's not introduce the full range of its products into the European market?
- What possible problems do you think Yeo's might have had in entering the European market?

Exam-style questions – Paper 1

- 1 YeyYo are a franchise chain selling cakes, biscuits and coffee. The company wants to change its marketing strategy to increase its market share. It currently has its coffee shops in small towns and its target market are local people who shop and work in these towns. The prices are kept low because in the towns most people have low incomes. YeyYo want to start selling in city centres but the Marketing Director thinks they will need to change the decoration and furniture in the coffee shops to appeal to the higher income people in the city centres.
- a) What is meant by a 'marketing strategy'? [2]
 - b) Identify **two** questions the Marketing Director will ask before deciding a new price for the coffee shops. [2]
 - c) Identify and explain **two** reasons why YeyYo might need a new marketing strategy to increase market share. [4]
 - d) Identify and explain **two** reasons why it is important for YeyYo to have an appropriate marketing strategy for a successful business. [6]
 - e) Do you think the Marketing Director is right to say the decoration and furniture needs to be changed for the city-centre coffee shops? Justify your answer. [6]
- 2 KKosmetics manufacture make-up for women. The company sells its products across Europe but wants to start selling to African countries. The Marketing Director says 'there are a lot of opportunities in these markets but also several problems. We are reaching saturation in the European markets and we need to increase sales in new markets.'
- a) What is meant by 'reaching saturation in the European markets'? [2]
 - b) Identify **two** ways a new market abroad for KKosmetics is different to a home market. [2]
 - c) Identify and explain **two** reasons why KKosmetics might want to enter new markets abroad. [4]
 - d) Identify and explain **two** possible problems for KKosmetics of entering new markets abroad. [6]
 - e) Do you think these problems can be easily overcome by KKosmetics? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- how to develop an appropriate marketing strategy in given circumstances
- to explain the nature and impact of legal controls related to marketing
- to explain the opportunities and problem of entering new markets abroad.

NOW – test your understanding with the revision questions on the CD-ROM.

Marketing: end of section case study (Paper 2 style)

ChocoCrocS

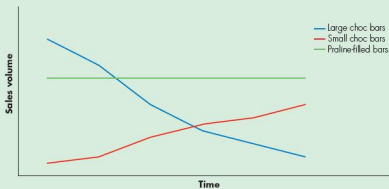


ChocoCrocS was set up ten years ago as a private limited company. The business grew slowly as the owners used reinvested profits as the only source of finance for expansion. The company has share capital of \$10 million which is owned by six members of the Patel family. ChocoCrocS has three main types of products which are:

- large chocolate bars mainly sold to men
- chocolates with praline filled centres mainly sold to women
- small chocolate bars shaped like a crocodile mainly sold to children.

ChocoCrocS employs skilled workers in the Marketing department. This department carries out market research and it also develops new products for the company to market. The Managing Director says this is one of the most important departments in the company. The Directors of ChocoCrocS want to expand the business.

Appendix 1: Sales for the products of ChocoCrocS



- 1 a) Appendix 1 shows large chocolate bars are in the decline stage of the product life cycle. Identify and explain four other stages of the product life cycle. [8]
- b) ChocoCrocS is considering what pricing strategy to use for the crocodile shaped children's chocolate bars. Consider three suitable pricing strategies it could use and recommend which one it should choose. Justify your answer. [12]
- 2 a) ChocoCrocS has a website which gives customers information about the products they sell. Identify and explain two other ways that ChocoCrocS could find the internet useful to the business in the marketing of its products. [8]
- b) The Marketing department is one of ChocoCrocS most important departments. Consider why market research is important to the success of ChocoCrocS. Justify your answer. [12]

Optional extra question

- 3 a) Identify and explain two ways the size of the ChocoCrocS company could be measured. [8]
- b) Consider the alternative ways the directors could expand ChocoCrocS. Recommend which way it should choose. Justify your answer. [12]

Section

4

Operations management

Chapters

- 17 Production of goods and services
- 18 Costs, scale of production and break-even analysis
- 19 Achieving quality production
- 20 Location decisions



Zutritt verboten !
Ende des
Schutzbereiches

Production of goods and services

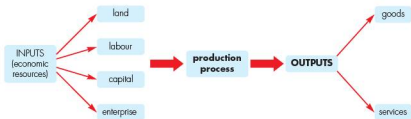
This chapter will explain:

- what is meant by production and productivity
- the benefits of increasing productivity
- why businesses hold inventories (stock)
- lean production
- methods of production
- how technology has changed production methods.

Managing resources effectively to produce goods and services

Production is the provision of a product or a service to satisfy consumer wants and needs. The process involves firms adding value to a product. As you learnt in Chapter 1, value added is the difference between the cost of inputs (raw materials or components) and the final selling price of the product or service.

The production process applies to manufacturing as well as service industries. In adding value, businesses combine the 'inputs' of a business (factors of production, such as land, labour, capital and enterprise) to produce more valuable 'outputs' (the final good or service) to satisfy consumer wants or needs. However, these factors of production, also called economic resources, can be combined in different proportions – as inputs – to the production process, as shown in the diagram below.



For a business to be competitive it should combine these inputs of resources efficiently so that the business makes the best use of resources at its disposal to keep costs low and increase profits. In a developing country, where wages are low, it may be more efficient to use many workers and few machines to produce goods – the production process is called 'labour-intensive'. However, in developed countries where labour costs are high, then production is often 'capital-intensive', where businesses use machines/robots and employ few workers.

Case study example

A restaurant combines the four factors of production to produce a restaurant meal for customers.



The same process happens for manufacturing.

Operations department

The Operations department's role in a business is to take inputs and change them into outputs for customer use. Inputs can be physical goods or services.

The Operations Manager is responsible for making sure that raw materials are provided and made into finished goods or services. The different sections of this department will vary depending on what the business produces. A typical manufacturing business will have:

- a Factory Manager who will be responsible for the quantity and quality of products coming off a production line. This will include the maintenance of the production line and other necessary repairs
- a Purchasing Manager who will be responsible for providing the materials, components and equipment required for the production
- a Research and Development Manager who will be responsible for the design and testing of new production processes and products.

In a retailing business this department will be similar but the Factory Manager will be replaced by the managers for the shops. In a service business such as a restaurant business then the Operations department will include managers for each of the restaurants (see the organisation charts in Chapter 7).

Productivity

The level of production is the output of the business. This is different to productivity.

Productivity is how a business can measure its efficiency. The productivity of a business can be measured by:

$$\text{Productivity} = \frac{\text{Quantity of output}}{\text{Quantity of inputs}}$$

Definitions to learn

Productivity is the output measured against the inputs used to create it.

Businesses often want to measure the productivity of one of the factors of production or inputs, usually labour. This is measured by dividing the output over a given period of time by the number of employees:

$$\text{Labour productivity} = \frac{\text{Output (over a given period of time)}}{\text{Number of employees}}$$

Productivity can either mean using fewer inputs to produce the same output or using the same inputs to produce a much greater output.

As employees become more efficient, the amount of output produced per employee will rise and therefore the costs of producing the product will fall.

Businesses strive to increase productivity in order to become more competitive.

Different levels of success at being productively efficient account for the difference between a firm's ability to be competitive, remain trading and being able to generate profits.

Tips for success

Make sure you can discuss the effects of increased productivity on employers and employees. How are the effects different?

Activity 17.1

Better Bakers produce cakes for local supermarkets. It has steadily increased the number of workers it employs. The owner, Benson, thinks this has been good for the business as output has increased.

a) Do you agree with the owner? Use the information below to justify your answer.

| Year | Output = number of cakes produced | Number of workers | Output per worker |
|------|-----------------------------------|-------------------|-------------------|
| 2012 | 10 000 | 30 | |
| 2013 | 20 000 | 40 | |
| 2014 | 25 000 | 50 | |

b) Suggest how the owner, Benson, could increase the productivity of Better Bakers.

c) Can Benson measure the output of his office workers? If so, how?

There are a number of ways to increase productivity. These include:

- improving the layout of the machines in a factory to reduce wasted time and therefore increase efficiency
- improving labour skills by training workers so they have more productive techniques of working
- introducing automation.

Revision summary: ways to increase productivity



Benefits of increasing efficiency/productivity

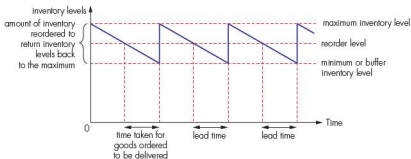
- Increased output relative to the inputs required.
- Lower costs per unit (average cost).
- Fewer workers may be needed, possibly leading to lower wage costs.
- Higher wages for workers increases motivation.

Why businesses hold inventories (stock)

Have you ever gone into a shop and found they have run out of what you wanted? If so, then the shop might have had higher sales than usual or else their delivery of stock might have been late. To ensure that there is always enough inventory to satisfy demand, inventory levels must be carefully controlled.

Inventories can take various forms, including raw materials, components, partly finished goods, or finished products ready for delivery. It can even include inventory of spare parts for machinery in case of breakdowns.

When inventories get to a certain point (reorder point), they will be reordered to bring inventories back up to the maximum level again. The business must reorder before inventories get too low to allow time for the goods to be delivered. If inventory levels get too low they might actually run out if there is an unexpectedly high demand for the goods. If too high a level of inventory is held then this costs a lot of money; the business has bought the goods but they are not being used and the money could be put to better use. The following graph demonstrates how inventory levels can be managed.



Definitions to learn

The **buffer inventory level** is the inventory held to deal with uncertainty in customer demand and deliveries of supplies.

Lean production is a term for those techniques used by businesses to cut down on waste and therefore increase efficiency, for example, by reducing the time it takes for a product to be developed and become available for sale.

Effectively managing inventory levels is very important to all types of businesses, especially manufacturing and retail businesses.

Lean production

Lean production covers a variety of techniques used by businesses to cut down on waste and therefore increase efficiency. It tries to reduce the time it takes for a product to be developed and become available in the shops for sale, so that it is as quick as possible. Lean production cuts out any activities which do not add value for the customer and this can apply to services as well.

There are seven types of waste that can occur in production and they are:

- overproduction – producing goods before they have been ordered by customers. This results in high storage costs and possible damage to goods whilst in storage

- waiting – when goods are not moving or being processed in any way then waste is occurring
- transportation – moving goods around unnecessarily causes waste and is not adding value to the product. Goods may also be damaged when they are being moved around
- unnecessary inventory – if there is too much inventory then this takes up space, may get in the way of production and costs money
- motion – any actions, including bending or stretching movements of the body of the employee wastes time. It may also be a health and safety risk for the employees. This also applies to the movement of machinery which may not be necessary
- over-processing – if complex machinery is being used to perform simple tasks then this is wasteful. Some activities in producing the goods may not be necessary if the design of the product is poor
- defects – any faults require the goods being fixed and time can be wasted inspecting the products.

Activity 17.2

Choose a business activity with which you are familiar – for example a restaurant, café or hairdressers – and identify examples of the seven types of waste which might occur. How could these wastes be eliminated?

Benefits of lean production

Costs are saved through:

- less storage of raw materials or components
- quicker production of goods or services
- no need to repair defects or provide a replacement service for a dissatisfied customer
- better use of equipment
- cutting out some processes which speeds up production
- less money tied up in inventories
- improved health and safety leading to less time off work due to injury.

Reduced costs can lead to lower prices for customers, businesses being more competitive and possibly also increased profits.

Lean production might include using the following methods:

- Kaizen
- just-in-time inventory control
- cell production.

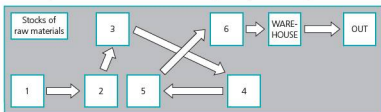
Definitions to learn

Kaizen is a Japanese term meaning 'continuous improvement' through the elimination of waste.

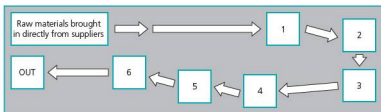
Kaizen

Kaizen means 'continuous improvement' in Japanese and its focus is on the elimination of waste. The improvement does not come from investing in new technology or equipment but through the ideas of the workers themselves. Small groups of workers meet regularly to discuss problems and possible solutions. This has proved effective because no one knows the problems that exist better than the workers who work with them all the time, so they are often the best ones to think of ways to overcome them.

Kaizen eliminates waste, for example, by getting rid of piles of inventory or reducing the amount of time taken for workers to walk between jobs so that they eliminate unnecessary movements. When Kaizen is introduced, the factory floor is reorganised by repositioning machines tightly together in cells, in order to improve the flow of production through the factory. The floor will be open and marked with colour-coded lines which map out the flow of materials through the production process.



The Kaizen effect: before



The Kaizen effect: after

Activity 17.3

Identify the changes that have taken place in the reorganisation of the factory floor using Kaizen principles.

The advantages of Kaizen might be:

- increased productivity
- reduced amount of space needed for the production process
- work-in-progress is reduced
- improved layout of the factory floor may allow some jobs to be combined, thereby freeing up employees to carry out some other job in the factory.

Just-in-time inventory control

Just-in-time or **JIT** is a production method whose focus is on reducing or virtually eliminating the need to hold inventories of raw materials or components and on reducing work-in-progress and inventories of the finished product. The raw materials or components are delivered just in time to be used in the production process, the making of any parts is undertaken just in time to be used in the next stage of production and the finished product is made just in time to be delivered to the customer.

- All this reduces the costs of holding inventory, as no raw materials and components are ordered to keep in the warehouse just in case it is needed.

Definitions to learn

Just-in-time (JIT) is a production method that involves reducing or virtually eliminating the need to hold inventories of raw materials or unsold inventories of the finished product. Supplies arrive just at the time they are needed.

- Warehouse space is not needed, again reducing costs.
- The finished product is sold quickly and so money will come back to the business more quickly, helping its cash flow.

To operate just-in-time, inventories of raw materials, work-in-progress and finished products are run down and no extra inventory is kept. The business will therefore need very reliable suppliers and an efficient system of ordering raw materials or components.

Cell production

Cell production is where the production line is divided into separate, self-contained units (cells), each making an identifiable part of the finished product, instead of having a flow or mass production line. This method of production improves the morale of the employees and makes them work harder so they become more efficient. The employees feel more valued and are less likely to strike or cause disruption.

Case study example

Tara wanted to start her own business. She knew that Thai food restaurants were very popular and she was an excellent cook of Thai food. She decided to start cooking dishes of Thai food and selling them to local people for dinner parties. She advertised in the local newspaper and used her own kitchen to prepare the food. Customers would ask her to cook a particular dish of their choice and she would cook it especially for them just how they wanted it. The food was extremely popular and soon she had many more orders for dinner parties than she could cope with and had to turn down customers.

So Tara decided to rent a small factory unit in which she could put large cookers. She expanded and took on several employees to help her. The number of orders received continued to grow as her reputation for producing excellent food spread. Shops started to order large quantities of a particular dish and they would sell it to customers in smaller containers as a takeaway dinner which they could heat up at home. In the new premises Tara did things slightly differently. Now, instead of making one pan of a particular dish, she would make a large quantity in one go and then divide it into large containers ready to be sent out for sale. She would then make a large quantity of another dish, and so on. Still the popularity of the food grew!

After about two years of expanding at the small factory unit, Tara decided she could afford to buy much larger premises and invest in new automated machinery to cook the food. The demand was there, the food sold to airlines, hotels and supermarkets, as well as the original shops. The new automated process would produce particular dishes in very large quantities, and would produce the same dish continually.

Activity 17.4

Read the case study above.

- a) What are the different methods of production that Tara used as her business expanded?
- b) Why do you think she changed production methods as her businesses expanded?

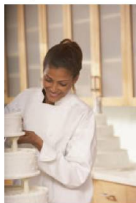
Methods of production

Tara used three main methods of production during the growth of her company:

- job production
- batch production
- flow production.

Definitions to learn

Job production is where a single product is made at a time.

Job production

This is where products are made specifically to order, for example, a customer would order a particular cake and Tara would make it. Each order is different, and may or may not be repeated. Other examples include: specialist machinery manufacturers who will manufacture a machine for another business to meet a particular specification, bridges, ships, made-to-measure suits, cinema films, or individual computer programs that perform specialised tasks.

Advantages of job production

- It is most suitable for personal services or 'one-off' products.
- The product meets the exact requirements of the customer.
- The workers often have more varied jobs (they don't carry out just one task).
- More varied work increases employee motivation – giving them greater job satisfaction.
- It is flexible and often used for high-quality goods and services meaning that a higher price can be charged.

Disadvantages of job production

- Skilled labour is often used.
- The costs are higher because it is often labour intensive.
- Production often takes a long time.
- Products are specially made to order and so any errors can be expensive to correct.
- Materials may have to be specially purchased leading to higher costs.

Definitions to learn

Batch production is where a quantity of one product is made, then a quantity of another item will be produced.

Batch production

This is where similar products are made in blocks or batches. A certain number of one product is made, then a certain number of another product is made, and so on. Tara made a batch of one type of cake and then made a batch of another type of cake, etc. Other examples include: a small bakery making batches of bread, several houses built together using the same design, furniture

production (a certain number of tables are made, then a certain number of chairs), or clothing (a batch of a particular size of jeans is produced and then a batch of another size).

Advantages of batch production

- It is a flexible way of working and production can easily be changed from one product to another.
- It still gives some variety to workers' jobs.
- It allows more variety to products which would otherwise be identical. This gives more consumer choice (for example, different flavours of ready-meals).
- Production may not be affected to any great extent if machinery breaks down.

Disadvantages of batch production

- It can be expensive as semi-finished or finished products will need moving about.
- Machines have to be reset between production batches which means there is a delay in production and output is lost.
- Warehouse space will be needed for stocks of raw materials and components. This is costly.

Flow production

Definitions to learn

Flow production is where large quantities of a product are produced in a continuous process. It is sometimes referred to as mass production.



This is when large quantities of a product are produced in a continuous process. It is sometimes referred to as mass production because of the large quantity of a standardised product that is produced.

It is called flow production because products look as if they are flowing down the production line (they move continuously along a production line).

The basic ingredients are put together at one end of the production line and then the product moves down and more parts are added, and so on, until the product is finished and packaged ready for sale. Large numbers of identical products are made and the costs of production are low (the business will gain from economies of scale). Examples of products produced in this way include: cars, cameras, televisions, packaged foods and drinks; in fact any mass produced, standardised product which is sold to a mass market will be produced in this way.

Advantages of flow production

- There is a high output of a standardised product.
- Costs are kept low and therefore prices are also lower.
- It is easy for capital-intensive production methods to be used – reducing labour costs and increasing efficiency.
- Capital-intensive methods allow workers to specialise in specific, repeated tasks and therefore the business may only need relatively unskilled workers – little training may be needed.
- It may benefit from economies of scale in purchasing.
- Low average costs and therefore low prices usually mean high sales.
- Automated production lines can operate 24 hours a day.
- Goods are produced quickly and cheaply.
- There is no need to move goods from one part of the factory to another as with batch production, so time is saved.

Tips for success

Make sure you can choose a suitable method of production for different products or a particular business.

Disadvantages of flow production

- It is a very boring system for the workers, so there is little job satisfaction, leading to a lack of motivation for employees.
- There are significant storage requirements – costs of inventories of raw materials/components and finished products can be very high.
- The capital costs of setting up the production line can be very high.
- If one machine breaks down the whole production line will have to be halted.

Factors affecting which method of production to use

The factors which determine which method of production to use are as follows.

- *The nature of the product.* If a fairly unique product or an individual service is required (in fact many services are individual to the customer and will be specifically tailored to their requirements), job production will be used. If the product can be mass produced using an automated production line then flow production will be used.
- *The size of the market.* If demand is higher and more products can be sold but not in very large quantities, batch production will be used. The product will be produced in a certain quantity to meet the particular order. Small local markets or niche markets will be served by businesses using job or batch production. International markets are served by businesses using flow production.
- *The nature of demand.* If there is a large and fairly steady demand for the product, such as soap powder, it becomes economic to set up a production line and continuously produce the product (flow production). If demand is less frequent, such as for furniture, then production may be more likely to be job or batch production.
- *The size of the business.* If the business is small and does not have the access to large amounts of capital then it will not produce on a large scale using automated production lines. Only large businesses can operate on this scale. Small businesses are more likely to use job or batch production methods.

Activity 17.5

- What method of production is used by each of the following businesses? Explain the reasons for your choice.
 - Walls manufacture well-known brands of ice cream. The ice creams are sold in many different shops and other outlets, and millions are sold a year.
 - Alexander is a hairdresser. He styles men's hair and has a number of regular customers.
- Hudson Limited have been in business for ten years manufacturing components for cars. They sell to several large car producers. Hudson Limited want to expand and manufacture components for aircraft engines. They have decided to build a new factory abroad, near to where aircraft engines are manufactured. Some of the new components they plan to produce will be designed for only one type of engine, whereas most of the other components will be standardised and used in several different models of engine. Hudson Limited have chosen the new site for the factory but have not decided on the method of production to use. You have been asked to advise them on what to use. Explain your choice of the method(s) of production they should use.

How technology has changed production methods

Technological advances have allowed the mechanisation and automation of production methods in many industries. For example, the car industry is almost entirely automated. The use of automation, robotics and CAD/CAM keeps businesses ahead of the competition, keeps costs falling, reduces prices and improves the products manufactured.

- **Automation** is where the equipment used in the factory is controlled by a computer to carry out mechanical processes, such as paint spraying on a car assembly line. The production line will consist mainly of machines and only a few people will be needed to ensure that everything proceeds smoothly.
- **Mechanisation** is where the production is done by machines but operated by people, for example, a printing press. Robots are machines that are programmed to do tasks, and are particularly useful for unpleasant, dangerous and difficult jobs. They are quick, very accurate and work non-stop 24 hours a day.
- **CAD (computer aided design)** is computer software that draws items being designed more quickly and allows them to be rotated to see the item from all sides instead of having to draw it several times. It is used to design new products or to re-style existing products. It is particularly useful for detailed technical drawings.
- **CAM (computer aided manufacture)** is where computers monitor the production process and control machines or robots on the factory floor. For example, on the production line of a car plant computers will control the robots that spot-weld the car body together or the robots that spray paint the car.
- **CIM (computer integrated manufacturing)** is the total integration of computer aided design (CAD) and computer aided manufacturing (CAM). The computers that design the products are linked directly to the computers that aid the manufacturing process.



Technology has also improved productivity in shops with electronic payment methods and scanners at the tills.

- **EPOS (electronic point of sale)**. This is used at checkouts where the operator scans the bar code of each item individually. The price and description of the item is displayed on the checkout monitor and printed on the till receipt. The inventory record is automatically changed to show one item has been sold and if inventory is low (at the reorder point) then more inventory can be automatically ordered.

● **EFTPOS** (*electronic funds transfer at point of sale*).

This is where the electronic cash register is connected to the retailer's main computer and also to banks over a wide area computer network. The shopper's card will be swiped at the till and the bank information will automatically be read from the card. The money will be directly debited from the customer's account after they have signed for the debit to be made or have entered their PIN (personal identification number). A receipt will be printed as confirmation that the payment has gone out of the customer's account.



Tips for success

Make sure you can discuss the effects of new technology on employers and employees. How are the effects different?

The advantages of new technology

- Productivity is greater as new production methods are used.
- Greater job satisfaction stimulates workers, as routine and boring jobs are now done by machines.
- The types of jobs have changed as more skilled workers are needed to use the new technology. Businesses must offer training to existing workers in the use of new technology. The workers are more motivated and therefore improve the quality of their work.
- Better quality products are produced owing to better production methods and better quality control.
- More accurate consumer demand results from computers being used to monitor inventory levels.
- Quicker communication and reduced paperwork, owing to computers, lead to increased profitability.
- The information that is available to managers is much greater and this results in better and quicker decision making.
- New products are introduced as new methods of production are introduced. The market and tastes of the consumer have changed.

The disadvantages of new technology

- Unemployment rises as machines/computers replace people on the factory floor and in offices.
- It is expensive to invest in, which also increases the risks as large quantities of products need to be sold to cover the cost of purchasing the equipment.
- Employees are unhappy with the changes in their work practices when new technology is introduced.
- New technology is changing all the time and will often become outdated quite quickly and need to be replaced if the business is to remain competitive.

Activity 17.6

- Choose a business that manufactures a product and find out what new technology/equipment has been installed in the Operations department over the last five years.
- What are the advantages and disadvantages of these changes?
- How have these changes affected the business (for example, employment, profits, sales, quality of the products)?

Activity 17.7

- Choose a business that produces a service and find out what new technology/equipment has been installed in the business over the last five years. (This will probably be computers or specialised computer software.)
- What are the advantages and disadvantages of these changes?
- How have these changes affected the business (for example, employment, profits, sales, quality of service)?

International business in focus: Technology in banking



Nigerian banks, for example, GT Bank, Oceanic Bank, Zenith Bank and Intercontinental Bank, have found that most Nigerians are gradually losing the desire to carry cash around and most customers prefer banks with efficient online banking facilities as they do not like to queue in branch banks. Increasing profits and increasing the number of customers is a major incentive to change the way they provide banking services.

The impact of technology in banking is leading to fewer branch banks with face-to-face services to new channels of accessing banking services such as automated teller machines (ATMs), internet banking, point of sale terminals (POS) and mobile (cell) phone banking. Using these technologies allows banks to achieve economies of scale as well as responding to customers' preferences.

Discussion points

- Why are Nigerian banks changing the way they provide bank services?
- How is technology changing the way banks provide their services to customers?
- What benefits do the banks gain from introducing more technology into their business?

Exam-style questions – Paper 1

- 1 Carlos owns a private limited company called BettaBakers Limited. It produces a variety of cakes which are sold in local shops. The method of production used by BettaBakers is batch production. Carlos says 'I have been told that lean production techniques in the bakery would help me to increase profits'.
- a) What is meant by 'lean production'? [2]
 - b) Identify **two** ways lean production might be achieved. [2]
 - c) Identify and explain **two** ways, other than lean production, Carlos could use to increase productivity. [4]
 - d) Identify and explain **two** advantages to Carlos of using batch production. [6]
 - e) Do you think Carlos should change his production methods to flow production in the bakery? Justify your answer. [6]
- 2 Mr Patel owns a business which manufactures wooden furniture. He uses traditional labour-intensive methods of production in the factory. The furniture made is to the exact requirements of the customer. Mr Patel is worried about productivity in his factory and wants to improve it. He is thinking of introducing new technology into his factory.
- a) What is meant by 'productivity'? [2]
 - b) Identify **two** benefits to Mr Patel of increasing productivity. [2]
 - c) Identify and explain **two** ways technology could change production methods for Mr Patel. [4]
 - d) Identify and explain **two** disadvantages of using job production for Mr Patel. [6]
 - e) Do you think Mr Patel should introduce new technology into his factory? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- the difference between production and productivity and to identify factors that increase productivity
- why businesses hold inventories (stocks)
- to identify and explain ways of implementing lean production
- to identify and explain the method of production used in a given situation (job, batch or flow production)
- how technology has changed production methods.

NOW – test your understanding with the revision questions on the CD-ROM.

Costs, scale of production and break-even analysis

This chapter will explain:

- why managers need to know the costs of operating their business
- the different types of costs
- the concepts of economies of scale and diseconomies of scale
- how to construct, complete and amend a break-even chart
- how break-even analysis helps managers make decisions.

Business costs

All business activities involve costs of some sort. These costs cannot be ignored. For example, the manager of a business is planning to open a new factory making sports shoes. Why does the manager need to think about costs? Some of the reasons are explained below.

- The costs of operating the factory can be compared with the revenue from the sale of the sports shoes to calculate whether or not the business will make a profit or loss. This calculation is one of the most important made in any business.
- The costs of two different locations for the new factory can be compared. This would help the owner make the best decision.
- To help the manager decide what price should be charged for a pair of sports shoes.

Accurate cost information is therefore very important for managers.

Definitions to learn

Fixed costs are costs which do not vary with the number of items sold or produced in the short run. They have to be paid whether the business is making any sales or not. They are also known as **overhead costs**. **Variable costs** are costs which vary directly with the number of items sold or produced.

Activity 18.1

These are some of the costs involved in opening and operating a new sports shoe factory:

- rent of the factory
- insurance of the factory
- bank fees
- raw materials used
- management salaries.

Add six other costs to this list that the owner would have to pay.

Fixed costs and variable costs

In calculating the costs of the business it is important to understand the difference between different types of costs. The main types of costs are **fixed costs** and **variable costs**. Examples of fixed costs include management salaries and rent paid for property. Even if output was zero, these costs would still have to be paid. Examples of variable costs include material costs and piece-rate labour costs. The more units that are produced, the higher these **variable costs** will be.

Tips for success

Avoid making this mistake: 'Fixed costs do not vary over time'. This is not true because a business might expand by building a new shop, factory or offices. Fixed costs are those that do not vary with the output of the business, given the existing factory, shop or office buildings.

Revision summary: business costs**Activity 18.2**

Separate the costs listed in Activity 18.1 and the six additional costs on your list into two lists: fixed costs and variable costs. Explain why you have put each cost under either 'fixed costs' or 'variable costs'.

Definitions to learn

Total costs are fixed and variable costs combined.
Average cost per unit is the total cost of production divided by total output (sometimes referred to as 'unit cost').

Total cost and average cost

The **total costs** of a business, during a period of time, are all fixed costs added to all variable costs of production. This total figure can then be compared with the sales revenue for the period to calculate the profit or loss made.

An **average cost per unit** can be calculated from the total cost figure. Average cost is the total cost of production divided by total output. For a sport shoe manufacturer, producing 30 000 pairs of shoes each year, this could be calculated as follows:

Stage 1

$$\text{Total costs of production } (\$150\,000) = \text{fixed costs } (\$50\,000) + \text{total variable costs } (\$100\,000)$$

Stage 2

$$\begin{aligned} \text{Average cost of production} &= \frac{\text{Total costs of production (in a time period)}}{\text{Total output (in a time period)}} \\ &= \frac{\$150\,000}{30\,000} = \$5 \text{ per pair} \end{aligned}$$

If both the average cost of production and the level of output is known, then total cost can be calculated by multiplying average cost per unit by output.

$$\text{Total cost} = \text{average cost per unit} \times \text{output}$$

Activity 18.3: Calculating total cost and average cost

A car manufacturer produces three models of vehicle, X, Y and Z. It has calculated the costs of these three products to be:

| | X | Y | Z |
|--------------------------------|------|--------|------|
| Variable material costs (\$ m) | 5 | 10 | 8 |
| Variable labour costs (\$ m) | 10 | 14 | 6 |
| Allocated fixed costs (\$ m) | 9 | 12 | 6 |
| Annual output of vehicles | 4000 | 12 000 | 5000 |

The total variable cost of manufacturing model X = \$15 million

Total cost of manufacturing model X = \$15 million + \$9 million = \$24 million

The average cost per unit of X = $\frac{\$24\,000\,000}{4000\text{ units}} = \6000 per vehicle

- Calculate the total variable cost of manufacturing vehicle models Y and Z.
- Calculate the total cost of manufacturing models Y and Z.
- Calculate the average cost of manufacturing models Y and Z.
- Identify and explain two possible uses of these results to managers of the car manufacturer.

Using cost data

Once a business has classified all costs into either fixed or variable, this information can be used to help make business decisions. Here are three examples.

| Use of cost data | Example | Explanation |
|-------------------------------------|--|---|
| Setting prices | Average cost of making a pizza = \$3. If the business wants to make \$1 profit on each pizza sold, it will charge a price of \$4. See Chapter 13 for more examples of cost-based pricing. | If the average cost per unit was not known, the business could charge a price that leads to a loss being made on each item sold. |
| Deciding whether to stop production | If the total annual cost of producing a product is \$25 000 but the total revenue is only \$23 000, then the business is making a loss and could decide to stop making the product. | No business will willingly continue to make a loss but the decision to stop making a product will also depend on whether: <ul style="list-style-type: none"> the product has just been launched on the market – sales revenue might increase in future the fixed costs will still have to be paid e.g. if the factory being used for the product is not sold. |
| Deciding on the best location | Location A for a new shop has total annual costs of \$34 000. Location B for a new shop has total annual costs of \$50 000. On this data alone, Location A should be chosen. | Costs are not the only factor to consider – there might not be any point in choosing a low-cost location for a new shop if it is in the worst part of town! |

Economies of scale and diseconomies of scale

Look again at the definition of average cost above. It is the cost of producing one unit of output. Would you expect all businesses in the same industry to have the same average costs? This would be rather unlikely.

Definitions to learn

Economies of scale are the factors that lead to a reduction in average costs as a business increases in size.

Case study example – cost of making bricks

Consider the average cost and total output of the following two businesses, which both make bricks.

| | Brick Co. A | Brick Co. B |
|------------------------|-------------|-------------|
| Total output per year | 10 million | 1 million |
| Average cost per brick | 50 cents | 75 cents |

The bigger company has much lower average costs than the smaller one. This cost advantage results from the economies of being a large business. These are called the **economies of scale**.

Activity 18.4

Read the case study above.

Explain three possible reasons why the unit cost of making bricks is lower for Brick Co. A than for Brick Co. B.

Economies of scale

There are five economies of scale.

Purchasing economies

When businesses buy large numbers of components, for example materials or spare parts, they are able to gain discounts for buying in bulk. This reduces the unit cost of each item bought and gives the firm an advantage over smaller businesses which buy in small quantities.

Marketing economies

There are several advantages for a large business when marketing its products. It might be able to afford to purchase its own vehicles to distribute goods rather than depend on other firms. Advertising rates in papers and on television do not go up in the same proportion as the size of an advertisement ordered by the business. The business will not need twice as many sales staff to sell ten product lines as a smaller firm needs to sell five.

Financial economies

Larger businesses are often able to raise capital more cheaply than smaller ones. Bank managers often consider that lending to large organisations is less risky than lending to small ones. A lower rate of interest is therefore often charged.

Managerial economies

Small businesses cannot usually afford to pay for specialist managers, for example marketing managers and qualified accountants. This tends to reduce their efficiency. Larger companies can afford specialists and this increases their efficiency and helps to reduce their average costs.

Technical economies

There are many of these, but a few examples will help to show how important they can be. Large manufacturing firms often use flow production methods (see Chapter 17). These apply the principle of the division of labour. Specialist machines are used to produce items in a continuous flow with workers responsible for just one stage of production. Small businesses cannot usually afford this expensive equipment. It could also be that they sell their products in small quantities and flow production could not be justified. The use of flow production and the latest equipment will reduce the average costs of the large manufacturing businesses.

In addition, some machinery is only made with a certain high output capacity. For example, an automatic welding machine can do 100 welds a minute. A small firm, if it bought such a machine, could not keep the machine working all day and the average cost of using it would be high. This is because the machinery is not 'divisible' into smaller capacity machines.

Diseconomies of scale

Is it possible for a business to become so large that it becomes less and less efficient? Is there a limit to economies of scale? Some research suggests that very large businesses may become less efficient than the smaller ones and this could lead to higher average costs for big firms.

How is this possible? It could occur because of certain **diseconomies of scale**.

Poor communication

The larger the organisation the more difficult it becomes to send and receive accurate messages. If there is slow or inaccurate communication then serious mistakes can occur which lead to lower efficiency and higher average costs. Poor communication in a large business with many managers is also considered in Chapter 9.

Low morale

Large businesses can employ thousands of workers. It is possible that one worker will never see the top managers of the business. Workers may feel that they are unimportant and not valued by the management. In small firms it is possible to establish close relationships between workers and top managers. The lack of these relationships in a big firm can lead to low morale and low efficiency amongst the workers. This will tend to push up average costs.

Slow decision making

It often takes longer for decisions made by managers to reach all groups of workers and this could mean that it will take a long time for workers to respond and act upon managers' decisions. The top managers will be so busy directing the affairs of the business that they may have no contact at all with the customers of the firm and they could become too removed from the products and markets the firm operates in.

Tips for success

Economies of scale can result in lower average (or unit) costs not lower total costs. A large business is likely to have higher total costs than a small one – but lower average costs. Make sure you can explain this.

Definitions to learn

Diseconomies of scale are the factors that lead to an increase in average costs as a business grows beyond a certain size.

It is very difficult to 'prove' that these diseconomies exist in practice. However, many very large businesses are now breaking themselves up into smaller units which can control themselves and communicate more effectively. This trend is aimed at preventing diseconomies of scale from reducing efficiency and raising average costs.

Revision summary: economies and diseconomies of scale



Activity 18.5: Comparing costs between two businesses

The following cost data has been collected from two shoe manufacturing companies.

| | Company A | Company B |
|--------------------------------|-----------|-----------|
| Annual output – pairs of shoes | 20 000 | 700 000 |
| Variable cost per shoe | \$4 | \$2.50 |
| Annual fixed costs | \$120 000 | \$2.1m |

- Calculate the total annual cost of manufacturing shoes for both businesses.
- Calculate the average cost per unit (pair of shoes).
- Identify and explain three reasons why the average total cost (per unit) for Company B is lower than for Company A.
- Identify and explain two benefits gained by Company B as a result of lower average cost (cost per unit).

Definitions to learn

Break-even level of output is the quantity that must be produced/sold for total revenue to equal total costs (also known as break-even point).

Break-even charts: comparing costs with revenue

The concept of break-even

'Break-even' is a very important idea for any business – especially a newly set up business. The **break-even level of output** or sales indicates to the owner or manager of a business the minimum level of output that must be sold so that total

costs are covered. At this break-even level of output it is important to note that a profit is **not** being made – but neither is a loss! The ‘quicker’ a newly set up business can reach break-even point the more likely it is to survive – and go on to make a profit. If a business never reaches break-even point then it will always make a loss.

The break-even level of output can be worked out in two ways – by drawing a break-even chart or graph and by calculation.

Drawing a break-even chart

In order to draw a **break-even chart** we need information about the fixed costs, variable costs and **revenue** of a business. For example, in a sports shoe business we will assume that:

- fixed costs are \$5000 per year
- the variable costs of each pair of shoes are \$3
- each pair of shoes is sold for a price \$8
- the factory can produce a maximum output of 2000 pairs of shoes per year.

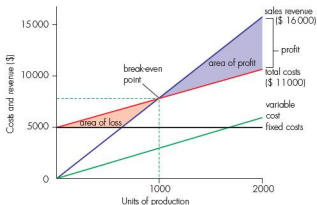
To draw a break-even chart it will help if a table, such as the one below, is completed. Take note of variable costs and revenue when no output is being produced. Clearly, there will be no variable costs as no shoes are being made and, as no shoes are being sold, there will be no revenue.

| | Sales (\$) = 0 | Sales (\$) = 500 | Sales (\$) = 2,000 units |
|----------------|----------------|------------------|--------------------------|
| Fixed costs | 5000 | 5000 | 5000 |
| Variable costs | 0 | 1500 | 6000 |
| Total costs | 5000 | 6500 | 11 000 |
| Revenue | 0 | 4000 | 16 000 |

When output is 2000 units, variable costs will be: $2000 \times \$3 = \6000 .

Assuming all output is sold, total revenue will be: $2000 \times \$8 = \$16\ 000$.

Make sure you understand how the other figures were arrived at before looking at how the data is used to construct a break-even graph.



Definitions to learn

Break-even charts are graphs which show how costs and revenues of a business change with sales. They show the level of sales the business must make in order to break even.

The **revenue** of a business is the income during a period of time from the sale of goods or services. Total revenue = quantity sold \times price.

Now we can plot the information on the graph. Note the following points:

- the 'y' axis (the vertical axis) measures money amounts – costs and revenue
- the 'x' axis (the horizontal axis) shows the number of units produced and sold
- the fixed costs do not change at any level of output
- the total cost line is the addition of variable costs and fixed costs.

What does the graph show?

The **break-even point** of production is where total costs and total revenue cross. The business must therefore sell 1000 pairs of shoes in order to avoid making a loss.

At production below the break-even point, the business is making a loss. At production above the break-even point, the firm makes a profit. Maximum profit is made when maximum output is reached and this is a profit level of \$5000.

Definitions to learn

The **break-even point** is the level of sales at which total costs = total revenue.

Case study – is Namib Tyres breaking even?

Namib Tyres Ltd produce motorcycle tyres. The following information about the business has been obtained.

- Fixed costs are \$30 000 per year.
- Variable costs are \$5 per unit.
- Each tyre is sold for \$10.
- Maximum output is 10 000 tyres per year.

Tips for success

Remember that a lower break-even point is better than a higher one! This is because it means that fewer units have to be sold before the business starts to make a profit.

Activity 18.6

Read the case study above.

| | Output = 0 | Output = 10 000 |
|----------------|------------|-----------------|
| Fixed costs | x | \$30 000 |
| Variable costs | 0 | a |
| Total costs | y | b |
| Revenue | z | \$100 000 |

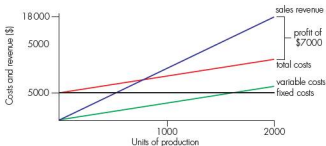
- Copy this table and fill in the missing figures.
- Draw a break-even chart from the information in the table.
- From your break-even chart identify:
 - the break-even level of output
 - the level of profit at maximum output.

Uses of break-even charts

Apart from the use we have already made of these graphs – identifying the break-even point of production and calculating maximum profit – there are other benefits of break-even charts.

Advantages of break-even charts

- Managers are able to read off from the graph the **expected profit or loss** to be made at any level of output.
- The impact on profit or loss of certain business decisions can also be shown by **redrawing the graph**. Consider again the sports shoe business. What would happen to the break-even point and the maximum output level if the manager decided to increase the selling price to \$9 per pair? This new situation can be shown on another break-even chart.



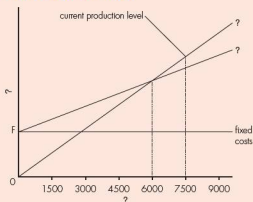
- Maximum revenue now rises to \$18 000. The break-even point of production falls to 833 units and maximum profit rises to \$7000. Seems like a wise decision! However, the manager needs to consider competitors' prices too and he may not be able to sell all 2000 pairs at \$9 each. This point is explained below.
- The break-even chart can also be used to **show the safety margin** – the amount by which sales exceed the break-even point. In the graph above, if the firm is producing 1000 units, the safety margin is 167 units (1000 – 833).

Limitations of break-even charts

The break-even chart is therefore useful to managers, but the technique does have some limitations, as listed below. These must be remembered by managers whenever they use these charts to help them take decisions.

- Break-even charts are constructed assuming that all goods produced by the firm **are actually sold** – the graph does not show the possibility that inventories may build up if not all goods are sold.
- Fixed costs only remain constant if the **scale of production does not change**. For example, a decision to double output is almost certainly going to increase fixed costs. In the case of the sports shoe business, an increase in output above 2000 will need a larger factory and more machinery.
- Break-even charts concentrate on the break-even point of production, but there are **many other aspects of the operations of a business** which need to be analysed by managers, for example how to reduce wastage or how to increase sales.
- The simple charts used in this section have assumed that **costs and revenues can be drawn with straight lines**. This will not often be the case; for example, increasing output to the capacity of a factory may involve paying overtime wage rates to production workers. This will make the variable cost line slope more steeply upwards as output expands. Also, in order to increase sales a business may need to offer discounts for large orders and this will cause the slope of the revenue line to be less steep.

Activity 18.7: Using break-even analysis



- Draw out this break-even graph and complete it with the following information:
 Fixed costs = \$6000
 Variable costs per unit = \$1
 Selling price = \$2.
 Label all of the lines/axes.
- Identify from your graph: the break-even level of output; the current safety margin; the level of profit at an output level of 9000.
- Explain what would happen to profit at output of 9000 units and the break-even point of production if the selling price was increased to \$3.
- Explain why the business might decide not to increase price to \$3.

Revision summary: uses and limitations of break-even charts



Break-even point: the calculation method

It is not always necessary to draw a break-even chart in order to show the break-even point of production. It is possible to calculate this. Study the following example.

Definitions to learn

The **contribution** of a product is its selling price less its variable cost.

Case study example

Cape Designs Ltd make wooden desks. The selling price of each desk is \$50. The variable costs of materials and production labour are \$20. The weekly fixed costs are \$6000. What is the break-even level of production? It is necessary to calculate the **contribution** of each desk. This is the selling price less the variable cost.

The calculation for the contribution of each desk is:

$$\begin{array}{rcl} \text{Selling price} - \text{Variable cost} & = & \text{Contribution} \\ \$50 & - & \$20 & = & \$30 \end{array}$$

Each desk gives a contribution to fixed costs and profit of \$30. In order to break even each week, the business must make sufficient desks, contributing \$30 each, to cover the fixed costs of \$6000.

The following formula should be used:

$$\begin{aligned} \text{Break-even level of production} &= \frac{\text{Total fixed costs}}{\text{Contribution per unit}} \\ &= \frac{\$6000}{\$30} = 200 \text{ units per week} \end{aligned}$$

Activity 18.8: Is the restaurant breaking-even?

A fast food restaurant sells meals for \$6 each. The variable costs of preparing and serving each meal are \$2. The monthly fixed costs of the restaurant amount to \$3600.

- How many meals must be sold each month for the restaurant to break even?
- If the restaurant sold 1500 meals in one month, what was the profit made in that month?
- If the cost of the food ingredients rose by \$1 per meal, what would be the new break-even level of production?

(This question could be answered by using a break-even graph.)

International business in focus: break-even points of car producers

The French car maker Peugeot and the American car maker General Motors (GM) are planning to form an alliance to build cars and components in Europe. This venture would be on such a large scale that average costs are likely to be lower than in the factories separately operated by the two companies. Over-capacity in the global car industry has led to price wars which have raised the break-even point of production for both of these manufacturers. Both businesses reported a large loss in 2012.

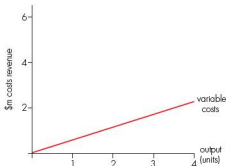
Another car maker, VW, is expanding its operations in Mexico. Lower labour and land costs, compared to Europe, help VW's factories in Mexico operate at a lower break-even point of production.

Discussion points

- Discuss why it is expected that the new Peugeot–GM combined factory will have lower average costs than existing factories.
- Assess ways in which car manufacturers could try to lower their break-even points of production in order to increase profits.

Exam-style questions – Paper 1

- 1 Sasha rents a market stall selling jewellery. She makes most of the jewellery herself but she also buys in items from large manufacturers. Her only other variable cost is the pay of her sales assistant who receives a small payment for each item she sells. Sasha wants to expand her business and she has found out that there is an empty shop near her home. The fixed costs of the shop are three times greater than those of the market stall.
- What is meant by 'variable costs'? [2]
 - Identify **two** fixed costs that Sasha has. [2]
 - Identify and explain **two** ways in which Sasha could reduce the break-even level of sales from her market stall. [4]
 - Identify and explain **two** reasons why large jewellery manufacturers can produce jewellery at a lower average cost than Sasha can. [6]
 - Would you advise Sasha to close her market stall and open a shop instead? Justify your answer. [6]
- 2 Popsquash plc is one of the world's largest makers of soft drinks. Sales have increased in recent years but profits have not. Rising fixed and variable costs have meant that higher sales revenue has not led to higher profits. The Chief Executive recently said: 'Perhaps the company is just too big to manage efficiently'. A new factory is planned for Country Z. An incomplete break-even chart is shown.



- What is meant by the term 'fixed costs'? [2]
- Identify **two** variable costs that Popsquash plc has. [2]
- Identify and explain **two** reasons why being 'too big' can lead to higher average costs. [4]
- Copy out and complete the break-even chart by adding:
 - Fixed costs of \$2 million [1]
 - Total costs [2]
 - Sales revenue assuming 4m drinks are sold at \$1.50 [1]
 - The break-even point of production [1]
 - Profit made at 4 million drinks. [1]
- Explain **two** ways in which Popsquash plc could try to reduce the break-even level of output in the new factory. Recommend to the Chief Executive which one the company should use. Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- the differences between fixed costs and variable costs
- why cost data is useful to business managers
- to understand the main causes of economies of scale and diseconomies of scale
- to understand what the break-even level of output means
- how to use break-even charts to find the break-even level of output and draw simple break-even charts
- how to explain the uses and disadvantages of break-even analysis.

NOW – test your understanding with the revision questions on the CD-ROM.

This chapter will explain:

- what is meant by quality and why it is important to all businesses
- the concept of quality control and how businesses implement quality control
- the concept of quality assurance.

What quality means and why it is important for all businesses

Imagine you went to the shops and bought a pair of jeans, took them home and found that they had a hole in them – you would not be a very happy customer! The business would get a bad reputation if this happened very often and would lose sales. You would probably take the jeans back to the shop and expect a replacement. If the shop refused to replace the jeans you would feel this was unfair which is why in some countries there are laws to protect consumers so that shops have to replace faulty products or refund the price. A business needs to try to ensure that all the products or services it sells are free of faults or defects.

This will ensure that the business:

- establishes a brand image
- builds brand loyalty
- will maintain a good reputation
- will help to increase sales
- attracts new customers.

But if quality is not maintained the business will:

- lose customers to other brands
- have to replace faulty products or repeat poor service which raises costs for the business
- have customers who tell other people about their experiences and this may give the business a bad reputation leading to lower sales and profits.

What does **quality** mean? Quality does not just mean producing a high-quality product or service. Ask yourself this question – if you buy a low-priced remote-controlled toy car would you expect it to work as well as an expensive toy car? The answer will probably be no. But you do expect the low-priced product to be perfect and not have any faults.



Definitions to learn

Quality means to produce a good or a service which meets customer expectations.

Tips for success

Remember that 'quality' does not only mean producing a high-quality good or service.

Activity 19.1

What do you, as a customer, expect from the following products or services:

- a meal at McDonald's
- a meal at a restaurant at the Sail hotel in Dubai
- a Ferrari car
- Tata's Nano car
- football lessons from a coach at a local football club
- football lessons from the coach at Barcelona FC?



A manufacturing business needs a product with a good design, then it needs to ensure that it is manufactured without any faults and the product needs to satisfy the wishes of the customer. A service providing business needs to match customer expectations with its level of customer service, delivery times and convenience.

Therefore quality is a very important part of any business in both the manufacturing and service sectors. There are several ways businesses can ensure that they produce a good quality product or provide a good service.

Definitions to learn

Quality control is the checking for quality at the end of the production process, whether it is the production of a product or service.

Quality control

A traditional way to make sure that products went out of factories with no defects was to have **Quality Control** departments whose job it was to take samples at regular intervals to check for errors. If errors or faults were found then a whole batch of production might have to be scrapped or reworked. The Quality Control department would check that quality was being maintained during the production of goods, try to eliminate errors before they occurred, and find any defective products before they went out of the factory to customers. A business may also use a 'mystery customer' to test out the service to check if the quality is as expected.

Advantages include:

- tries to eliminate faults or errors before the customer receives the product or service
- less training required for the workers.

However, there are drawbacks:

- expensive as employees need to be paid to check the product or service
- identifies the fault but doesn't find why the fault has occurred and therefore is difficult to remove the problem
- increased costs if products have to be scrapped or reworked or service repeated.

Quality assurance

This takes a slightly different approach to quality. The business will make sure quality standards are set and then it will apply these quality standards throughout the business. The purpose of quality assurance is to make sure that the customer is satisfied, with the aim of achieving greater sales, increased added value and increased profits. To implement a **quality assurance** system, several aspects of production must be included. Attention must be paid to the design of the product, the components and materials used, delivery schedules, after-sales service and quality control procedures. The workforce must support the use of this system or it will not be effective.

Advantages include:

- tries to eliminate faults or errors before the customer receives the product or service
- fewer customer complaints
- reduced costs if products do not have to be scrapped or reworked or service repeated.

However, there are drawbacks:

- expensive to train employees to check the product or service
- relies on employees following instructions of standards set.

Total Quality Management (TQM) is one approach to implementing a quality assurance system.

Total Quality Management (TQM)

Again it is the influence of the Japanese that has changed the way quality is ensured in many businesses today. It is the idea of **Total Quality Management (TQM)** that is at the heart of many practices. TQM is the continuous improvement of products and processes by focusing on quality at each stage of production. It tries to get it right first time and not have any defects. There is an emphasis on ensuring that the customer is always satisfied, and the customer can be other people/departments in the same business that you are completing tasks for, not just the final customer. This should mean that quality is maintained throughout the business and no faults should occur, as all employees are concerned with ensuring that a quality good or service is delivered. TQM should mean that costs will fall. It is closely linked with Kaizen and the use of quality circles. Quality circles are where groups of workers meet regularly and discuss problems and possible solutions. Workers are encouraged to suggest new ideas to reduce waste and ensure zero defects.

Definitions to learn

Quality assurance is the checking for the quality standards throughout the production process, whether it is the production of a product or service.

Definitions to learn

Total Quality Management (TQM) is the continuous improvement of products and processes by focusing on quality at each stage of production.

Advantages include:

- quality is built into every part of the production of a product or service and becomes central to the ethos of all employees
- eliminates all faults or errors before the customer receives the product or service as it has a 'right first time' approach
- no customer complaints and so brand image is improved – leading to higher sales
- reduced costs as products do not have to be scrapped or reworked or service repeated
- waste is removed and efficiency increases.

However, there are drawbacks:

- expensive to train employees to check the product or service
- relies on employees following TQM ideology.



Tips for success

Make sure you can discuss the difference between quality control and quality assurance and select an appropriate method in a given situation.

Case study example



Rolls Royce manufactures aircraft engines for international airlines, such as Emirates and Cathay Pacific. The engines are produced individually using quality assurance methods. New engines are checked at every part of the production process and also an additional inspection is carried out at various stages in the process. Rolls Royce uses a form of TQM where every employee is responsible for ensuring quality, but in addition to this it also has specially trained employees to carry out further checks on the engines to be certain of zero defects.

Activity 19.2

Read the case study above.

- Why is producing a high quality product important to Rolls Royce?
- Do you think quality control would be a suitable method for ensuring quality at Rolls Royce? Justify your answer.



Some examples of quality marks

How can a customer be assured of a quality product or service?

If a customer wants to be sure that a product or service will meet particular standards then they can look for a quality mark associated with the product or service. The business can apply to have this quality mark on their goods or services and they will have to follow certain rules to be able to keep this quality mark. An example is the ISO (International Organisation for Standardization) which grants a business the right to use an ISO number in its literature and advertising.

Ensuring a good customer service is also important to service sector businesses. They may not usually use a quality mark to show they provide a good service, but by having a good reputation and recommendations by satisfied customers they will keep repeat customers as well as gain new ones. Internet sites, such as TripAdvisor, are useful ways for businesses to gain a good reputation if satisfied customers put positive reviews on the site. Of course bad reviews will give the business the opposite effect and they will lose many potential customers as well as the dissatisfied customer who posted the review.

Activity 19.3

- Look at products or services that are sold in your country. Do any of them have any marks on them to show that they are a quality product?
- Use the internet to find out what the International Organisation for Standardization (ISO) is.
- What does a business have to do to get ISO approval?
- Can you find any other similar standard bodies in your country or region?
- Why do you think a business would want to obtain one of these quality marks?

International business in focus – quality at McDonald's



McDonald's restaurants have a checklist for employees to follow when serving customers. This is to ensure that a customer is always served to the standard expected by the business. McDonald's have found that ensuring the same quality standard is achieved by training employees to follow the set of rules in preparation of food as well as the service of customers.

Discussion points

- Identify which type of quality checking system McDonald's is using.
- Discuss whether this is the best method for McDonald's to use.
- Consider why McDonald's want to ensure a quality service in their restaurants.

Exam-style questions – Paper 1

- 1 DR manufactures low priced flip-flop shoes. It sells its flip-flop shoes through supermarkets across the country in towns and cities. 'We need to use quality control when we manufacture the flip-flops to make sure they are good quality or our customers will not be happy', said the Operations Manager.
- a) What is meant by 'quality control'? [2]
 - b) Identify **two** other methods, apart from quality control, of ensuring quality flip-flops are manufactured. [2]
 - c) Identify and explain **two** benefits of using quality control to DR. [4]
 - d) Identify and explain **two** possible disadvantages of using quality control to DR. [6]
 - e) Do you think the owners of DR should gain a quality mark, such as the ISO quality mark, for its flip-flop shoes? Justify your answer. [6]
- 2 LK is a private limited company and it owns and operates three cafés in a city centre. Customers expect the cafés to provide a quality service and also be 'value for money'. There has been an increasing number of customer complaints and the owners of LK are thinking of introducing quality assurance into their business. The city centre also has cafés which have a brand image of high quality and charge high prices.
- a) What is meant by a 'quality service'? [2]
 - b) Identify **two** possible reasons for an increasing number of customer complaints at the cafés. [2]
 - c) Identify and explain **two** difficulties in introducing quality assurance into cafés. [4]
 - d) Identify and explain **two** reasons why the owner of LK wants to introduce quality assurance. [6]
 - e) Do you think the owner of LK should charge higher prices in the café if quality assurance is introduced? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- what is meant by quality and why it is important to all businesses
- about the concept of quality control and how businesses implement quality control
- about the concept of quality assurance.

NOW – test your understanding with the revision questions on the CD-ROM.

This chapter will explain:

- what factors affect the location of manufacturing business
- what factors affect the location of a service sector business
- what factors affect the location of retailing business
- what factors a business may consider when deciding which country to locate operations in
- the role of legal controls on location decisions.

Location of industry

The location of a business is usually considered either when the business is first setting up or when its present location proves unsatisfactory for some reason. The business environment is constantly changing and a business's objectives, for example expanding or increasing profits, may result in a location no longer being suitable. The business may decide to look for an alternative site or may decide to set up additional factories/shops either in the home country or abroad.

Many businesses operate on a large scale and look at location on a world level, not just on a national or continental level. This is often termed globalisation because firms plan many aspects of their business, such as location decisions, marketing and sales, on a global scale.

Factors affecting where a manufacturing business chooses to locate will usually be different from those factors affecting where a service sector business will set up, and so these are discussed separately even though some factors will be common to both.

Factors affecting the location of a manufacturing business

Production methods and location decisions

The type of production methods used in a manufacturing business is going to have a significant influence on the location of that business.



An example of flow production

- If job production is used, the business is likely to be on a small scale and so the influence of the nearness of components, for example, will be of less importance to the business than if flow production is used.

- If production is on a large scale, the location of component suppliers might be of greater importance because a large number of components will need to be transported and the cost will be high.

Market

Locating a factory near to the market for its products used to be thought important when the product gained weight – when it became heavier and more expensive to transport than the raw materials/components. An example might be a drinks manufacturer, where the bottles and ingredients are lighter than the filled bottles and so the factory may have to be located near to the main markets for the product.

Today, because transport is much improved, being near to markets is of less importance, even for weight-gaining or bulk-increasing products. If the product perishes quickly and needs to be fresh when delivered to the market, such as milk, bread or cakes, the factory might be located close to its retail outlets. However, ways of preserving food for longer have reduced the importance of this factor.

Raw materials/components

Similar to the weight-gaining or bulk-increasing products discussed above, the raw materials may be considerably heavier or more expensive to transport than the finished product. Where a mineral is processed from the ore, there will usually be considerable waste produced in this process. It is often cheaper to process the ore near to the mining site than to transport it elsewhere.



If a particular process uses many different components, a business might look very carefully at its location. If many of these component suppliers are located near to one another, it might be preferable to locate near to these suppliers. This was often a factor in car manufacturing, where many different components are used to assemble a car, but again improved transport has lessened this influence.

If the raw material needs to be processed quickly whilst still fresh, locating near to the raw material source is still important. An example is frozen vegetables or tinned fruits, which need to be processed quickly. There will also be a lot of waste generated which does not go into the packaging.

External economies of scale

In addition to component suppliers, firms which support the business in other ways might need to be located nearby. Support businesses which install and maintain equipment may be better if nearby so that they can respond quickly to breakdowns.

The local education establishments, such as universities, might have research departments who work with the business on developing new products – being in close contact may help the business to be more effective.

Availability of labour

To be able to manufacture products at least some labour will be necessary, even if it is not a great number. If particular skilled labour is needed, it may be easier and cheaper to recruit these employees if the business sets up in an area where people with the relevant skills live. If the manufacturing process requires a large number of unskilled workers, an area where there is high unemployment may be more suitable. Also, the wage rates paid to employees might vary and an area where wages are lower might be preferable.

Government influence

When a government wants to encourage businesses to locate in a particular area it will offer state-funded grants to encourage firms to move there. If an area has high unemployment, the government might give money to businesses who locate in that area. However, the government influence might be negative in that there might be regulations or restrictions on what businesses can do. In fact, a government can refuse to allow a business to set up altogether. An example might be where the business produces a harmful waste product during the manufacturing process and the government will not want the waste product, for example nuclear waste, to poison the surrounding area.

Tips for success

Make sure you can choose which location factors are the most important for a particular manufacturing business.

Transport and communications



Businesses usually need to be near to a transport system, be it road, rail, inland waterway, port or airport. Where the product is for export then the ability to easily get to a port will be important. A nearby motorway can reduce costs by speeding up the time spent delivering the products to market even when the market is quite a distance away.

Power and water supply

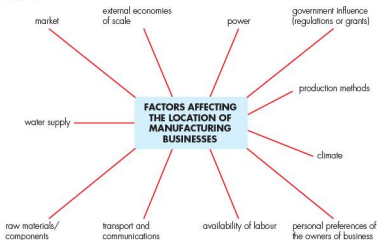
Today electricity is available in most places and therefore the availability of power is not so important. But to some industries having a reliable source of power, and therefore no regular power cuts, may be essential.

The same could be said of water as for power – a reliable supply will be needed. If large supplies of water are needed as part of the manufacturing process, for example, for cooling purposes with a power station, then being near to a water supply, such as the sea or a river, will be important.

Climate

This will not influence most manufacturing businesses but occasionally climate might be important. For instance, Silicon Valley in the US has a very dry climate which aids the production of silicon chips.

Revision summary: factors affecting the location of manufacturing businesses



Case study example

B&B plc manufactures food products. It wants to set up a factory to make a new ice cream. The new ice cream uses fresh ingredients – mainly freshly picked fruit – to maintain the fruits' flavour. The fruit used comes from one particular region of the country. This region is quite a long way away from the main cities where most of the country's population lives.

The production process is mainly automated and requires only a few skilled workers to supervise the equipment. It uses a lot of water in the mixture and also a lot of water to wash out the machinery every day to keep it clean.

The new ice cream is sold to domestic customers through supermarkets and other food stores. It is not sold abroad.

Activity 20.1

Read the case study above.

- Which factors affecting the location of manufacturing plants will be most important to this business when deciding where to locate? Explain why you think they will be important.
- Which do you think will be the most important factor and why?

Factors affecting the location of a service sector business

Customers

Locating a service sector business near its customers will be very important for certain types of services. These are usually services where direct contact between the business and the customer is required. If a quick response time is needed to serve the customers then the business needs to be located nearby. This would be true for plumbers and electricians who serve the local area in which they live. Other examples of personal services that need to be convenient for customers to use are hairdressers, beauticians, caterers, restaurants, cafés, gardeners, builders, post offices.

Some services do not need to be near to customers. Direct personal contact is not necessary as these services can be contacted by telephone, post or the internet. These businesses can therefore be located in different parts of the country or in different countries to where their customers live. With the increasing use of IT and the internet more and more firms are becoming free from the need to locate near to their customers.

Personal preference of the owners

The owners of businesses can influence where particular services choose to locate. They often locate their business near to where they live.

Technology



Technology has allowed some services to locate away from their customers. Some services are now conducted by telephone or via the internet and therefore the business itself does not need to be near to customers, for example website designers. These service businesses can locate anywhere and can therefore choose to locate on the outskirts of cities or even in remote areas (dependent on how many employees are required), so that they can take advantage of cheaper rent.

Availability of labour

If a service business requires a large number of employees then it cannot locate in remote areas. It will need to locate near to a large town or city. If a particular type of skilled labour is required then it may also have to locate near to where this labour is found. However, it is more likely that the particular skilled labour will move near to the business for work rather than the other way round.

Climate



Tips for success

Make sure you can choose which location factors are the most important for a particular service sector business.

Climate will affect some businesses particularly if they are linked to tourism in some way. Hotels often need to locate themselves where the climate is good and near to a beach.

Near to other businesses

Some services serve the needs of large businesses, such as firms that service equipment found in big companies. They will need to be nearby to respond quickly to a call to repair equipment. Services such as banks need to be near busy areas for the convenience of customers. However, internet banking has made this less important today.

Rent/taxes

If the service does not need to be on the main streets in a town or city centre, for example doctors, dentists or lawyers then the business will locate on the outskirts of town to benefit from lower rents and taxes.

Revision summary: factors affecting the location of a service sector business



Activity 20.2

For each of the services listed below:

- Choose four factors that you think are likely to affect its location.
- Explain how you think each factor will influence the location decision of:
 - Electrician (sole trader) serving domestic customers.
 - Computer software firm which writes computer games that are sold all over the world.
 - Small firm that trains people to scuba-dive and hires out scuba-diving equipment.

Factors affecting the location of a retailing business

Retail businesses are in the service sector but some special location factors often apply to these types of business.

Shoppers

Most retailers will want an area which is popular, such as a shopping mall/centre. The type of shopper an area attracts will also influence the attractiveness of the area to particular types of retailers. If the retailer sells expensive goods, it needs to be in an area where people on high incomes might visit; if the goods are small gift-type products, the retailer might want to be in an area visited by tourists.



Nearby shops

Being able to locate near to shops/businesses which are visited regularly, such as a post office or popular fast-food outlet, will mean that a lot of people pass your shop on the way to other shops and businesses and may go in to make a purchase. There may be many competitors nearby. You may think that this is bad for business, but it can also be a positive situation. If the business sells clothes, then being located near to many other clothes shops encourages people to visit the area as there is a lot of choice, therefore increasing business. If the clothes shop is in a position where there are no other similar shops nearby, it may not attract people to visit the shop as there will be limited choice.

Customer parking available/nearby

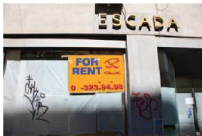
Where parking is convenient and near to the shops, this will encourage shoppers to that area and therefore possibly increase your sales. Lack of parking may put people off visiting the area and sales will be lower.

Availability of suitable vacant premises

If a suitable vacant shop or premises is not available for purchase or rent, the business may not be able to locate in the area it wishes.

Rent/taxes

The more central the site of the premises, the higher the rent and taxes will usually be. If a retail area is popular, there will be a high demand for sites in this area and therefore the cost of renting these sites will be higher. If the area is less popular, such as on the edge of town, the demand and therefore the rents will be lower.



Tips for success

Make sure you can choose which location factors are the most important for a particular retailing business.

Access for delivery vehicles

Access for delivery vehicles might be a consideration if it is very difficult for them to gain access to the premises.

Security

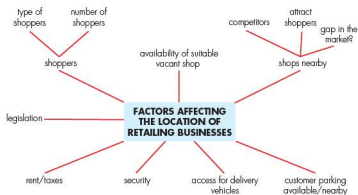
High rates of crimes such as theft and vandalism may deter a business from locating in a particular area. Insurance companies may not want to insure the business if it is

in an area of high crime. A shopping area which is patrolled by guards, even though it will be more expensive to rent the premises, might prove preferable.

Legislation

In some countries there may be laws restricting the trading or marketing of goods in particular areas.

Revision summary: factors affecting the location of retailing businesses



Case study example

B&C Limited are going to open a new shop selling fashion shoes. The shoes are good quality and are aimed at young women. B&C Limited have narrowed down the choice of where to locate the new shop to two nearby towns.

| | Town Y | Town Z |
|--|---|--|
| Population | 30 000 | 10 000 |
| % in age group: | | |
| 0–9 | 15 | 20 |
| 10–25 | 30 | 35 |
| 26–40 | 30 | 30 |
| 41–65 | 20 | 10 |
| 66+ | 5 | 5 |
| Unemployment | low | high |
| Crime rate | low | low |
| Shopping centre | large – about 100 shops | small – about 40 shops |
| Parking facilities | large car parks but queues build up at busy times | plenty of parking available – no problems at busy times |
| Types of shops in the shopping centre | clothes shops, shoe shops, banks, household goods, food shops | food shops, household goods, clothes shops, post office, banks |

Activity 20.3

Read the case study on page 248.

- Read the information on the two towns and then select which one will be the best location for the new shop. Justify your choice.
- What other information is needed to help make the final decision? Explain why the information is needed.

Locating in different countries

Multinational (transnational) companies have offices, factories, service operations or shops in many different countries. However, the rapid growth of newly industrialising countries, increasing international trade, improved global communications and improvements in transport have meant that many businesses can now consider where in the world to operate rather than just considering a single country; often called globalisation. Therefore this means that many more businesses, other than multinationals, are considering moving to another country, either to expand their operations or sometimes to relocate entirely, many from developed countries to rapidly growing economies.

A number of factors will affect whether a business decides to relocate to another country and which country to choose where to locate.

New markets overseas

When a business sees a steady increase in its sales overseas it may decide to relocate nearer to these markets rather than transport its products from the existing manufacturing base as it may be more cost effective. An example is JCB construction equipment which has built additional factories in Brazil and China as well as keeping its existing factory in the UK.

If the business is in the service sector, then locating near to its customers may be essential (for example Starbucks or ING financial services). The better the forecasts for growth in these markets then the more attractive the location for business.



Cheaper or new sources of materials

If the raw material source runs out, a business must either bring in alternative supplies from elsewhere or move to a new site in a country where it can more easily obtain these supplies. This is particularly true of mineral sources such as oil wells – these need to be in the country where the oil is found. Also it might be cheaper to use the raw materials at their source rather than transport them to another country to process.

Difficulties with the labour force and wage costs

If the business is located in a country where wage costs keep on rising, there may come a point when the business decides it is more profitable to relocate overseas, particularly labour-intensive businesses, to reduce wage costs. This has been true of many Western businesses moving their manufacturing plants to developing countries where the wages paid are much lower (for example, Vietnam for textile products). If particular types of skilled labour are needed by the business, the business might need to relocate to a different country where it can recruit the right type of labour. This has been true for businesses which employ staff with IT skills being attracted to locate in India which has a large number of graduates from university with IT-related degrees.

Rents/taxes considerations

If other costs such as rent or taxes (on profits or personal incomes) keep increasing this might cause the business to relocate to countries where these rents or taxes are lower.

Availability of government grants and other incentives

Governments may want to encourage foreign businesses to locate in their country to bring in investment and job opportunities. They may be willing to give grants, lower taxes or other incentives to businesses to induce them to come to their country rather than go elsewhere. Governments do this because the businesses will provide jobs and possibly teach new skills and import their technology into the economy.

Trade and tariff barriers

If there are trade barriers, such as tariffs (tax on imported goods) or quotas (where a limit is placed on the quantity of imports of a particular good), then by locating in that country there will be no restrictions. An example of this is the investment by Japanese car companies in Europe in order to get around the European Union's strict quotas for the import of cars.

Tips for success

Make sure you can choose which location factors are the most important for a particular business deciding which country to locate operations in.

Revision summary: factors that influence a decision to locate in a different country



Case study example

MT Furniture Limited wants to expand. Presently it is located in a small factory in the old part of the city. New markets are opening up abroad and MT has experienced a steady increase in its sales for the last five years. There is no room to build onto the existing factory and none of the adjacent factories are for sale. The business has been forced to look for another site if it wants to grow.

Because more and more of its sales are exported, it is considering whether to build a factory abroad or whether to build a larger factory in its home country. The following information has been gathered about two sites, one near MT's existing factory and one abroad in the country where most of MT's products are exported.

| | Site A – on the outskirts of the city near to existing factory in home country | Site B – in the main export market overseas |
|---------------------------------|--|---|
| Market | Large local market | Large export market and growing |
| Communications | Good communications – main roads connect to all parts of the country and the main port, which is several miles away | Good communications – main roads connect to all parts of the country and ports are very close to the site |
| Raw materials/components | Raw materials and components are close to the site – easily available | Raw materials and components are not close to the site – not easily available – some will need to be imported |
| Wage rates | High | Low – labour is very cheap |
| Skilled labour | Skilled workers employed at the present site – not too far from this site. Also additional skilled workers are available in the area | Very few skilled workers are available |
| Unemployment | Low | High |
| Rents/land taxes | High | Low |
| Government grants | No grants available | Grants paid towards capital investment when a new company is setting up in their country |

Activity 20.4

Read the case study on page 251.

Study the information provided and then write a report to the Board of Directors of MT Furniture Limited advising them of the advantages and disadvantages of each of the sites. Include a recommendation of which you think is the best site to choose. Remember to give reasons for your choice.

The role of legal controls on location decisions

The decisions by firms about where to locate their business can have a very important effect on the firm's profitability. Managers will want to locate their businesses in the best possible area, taking into account factors such as cost of land, proximity to transport links and customers, availability of workers, and so on. Why do governments try to influence these location decisions? Usually for two main reasons:

- to encourage businesses to set up and expand in areas of high unemployment – in some countries these are called development areas
- to discourage firms from locating in overcrowded areas or on sites which are noted for their natural beauty.

Two types of measures are often used by government to influence where firms locate.

- *Planning regulations* will legally restrict the business activities that can be undertaken in certain areas. For example, a business planning to open a factory in an area of residential housing might be refused planning permission. It would then be against the law for the firm to build the factory on this site. In certain parts of many countries, especially in particularly beautiful areas, it is not possible to establish any kind of business other than farming.
- Many governments provide grants or subsidies to businesses to encourage them to locate in undeveloped parts of the country. This assistance could be in the form of financial grants, such as a non-repayable amount of money paid to the business to locate in a particular area or subsidies paid to businesses (for example, low-rental factories). These development areas which receive government assistance usually have a very high unemployment rate and there is a great need for new jobs.

Tips for success

Make sure you can explain why governments might intervene in the location decisions of businesses.

Case study example: DEF Chemicals announce plans to build a new factory

Workers' leaders were delighted to hear today of plans by DEF Chemicals to build a huge new paint and chemicals plant in the Southern province. Many of these products will be sold abroad. The factory will create 1000 new jobs in an area badly affected by other factory closures. The new factory will require materials, components and supplies from many local firms. It is claimed that the Government is planning to offer substantial grants to DEF for locating in this area of high unemployment.

However, it has insisted that it should not be too close to housing estates and schools. The grants being offered have angered other firms in the same industry as being unfair competition for them.

Local residents have mixed feelings about the plans. One elderly resident claimed: 'It will only bring more road traffic and risk of pollution. Don't forget that one DEF plant in the North was destroyed by an explosion a few years ago, killing several workers.' However, other local people welcomed the news as it will bring more businesses and wealth to the area.

Activity 20.5

Read the case study above.

- Make a list of the stakeholders likely to be affected by DEF's plan to build a new chemical factory.
- For each of the groups that you have identified in a), explain why they are likely to be in support of, or are likely to oppose, these new plans.
- Explain three reasons why, in your opinion, the Government ought to be involved in this decision.

International business in focus – Chesapeake Bay Candle company



Chesapeake Bay Candle, a US company with its factories based in China, have decided to open a new factory in the US to supply their growing American market for candles. Rising wage costs of up to 40 per cent in China and a 6 per cent increase in shipping costs have led to this decision. 'In addition to cost considerations, to be successful in the American market the business needs to be able to produce and ship the products the next day to meet the quickly changing fashions in the market', says Ms Xu, the co-founder of the company. Import tariffs are high for Chinese made candles being imported into the US.

Discussion points

- Why has Ms Xu decided to build a new factory in America?
- How do you think Chesapeake Bay Candles might benefit from this location?

Exam-style questions – Paper 1

- 1 ABC Limited produces fruit juice drinks. The fruit to produce the drinks is grown locally on nearby farms. However, the fruit can also be imported at a cheaper price, but the quality is not as good. When producing the fruit drink there is a lot of waste from the parts of the fruit which are not used to make the drinks. Land near to the farm is available at a cheap price and the company wants to buy this land to expand rather than relocate the factory to another country. The market for fruit drinks is both at home and overseas.
- a) What is meant by 'relocate the factory'? [2]
 - b) Identify **two** reasons why ABC Limited buys its fruit from nearby farms. [2]
 - c) Identify and explain **two** factors which influenced the location decision of ABC Limited when choosing its original site. [4]
 - d) Identify and explain **two** reasons why ABC might want to buy land nearby to its existing factory to expand rather than relocate to another country. [6]
 - e) The Government is offering grants to relocate to another area of the country. Do you think the managers of ABC Limited should take advantage of these government grants? Justify your answer. [6]
- 2 SalesRUS is a chain of large clothes shops. The owners are looking for a location in the city centre for a new shop. The existing shops sell a range of clothes for men and women at low prices and are all located in busy shopping malls. There is a lot of competition from similar shops and the Managing Director thinks the new shop should not be located near to competitors.
- a) What is meant by 'competitors'? [2]
 - b) Identify **two** advantages of a shop being located in a small town rather than the city centre. [2]
 - c) Identify and explain **two** ways the Government might influence the decision of where to locate the new shop. [4]
 - d) Identify and explain **two** ways in which the location chosen for the new shop might have an effect on its profitability. [6]
 - e) Do you think the Managing Director is right in not wishing to locate the new shop near to its competitors' shops? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- to identify the relevant factors that affect the location of a manufacturing business
- to identify the relevant factors that affect the location of a service sector business
- to identify the relevant factors that affect the location of a retailing business
- to identify the relevant factors that a business considers when deciding which country to locate operations in
- about the role of legal controls on location decisions.

NOW – test your understanding with the revision questions on the CD-ROM.

Operations management: end of section case study (Paper 2 style)

Premium Suits

Sally owns a business called Premium Suits. It is a Private Limited Company. The business makes suits for men using batch production and the production workers are paid an hourly wage. Sally employs 100 people who work on the production of suits. She has five employees who help her in the office but she only has one manager who is responsible for finance. Sally carries out all the other functions for the business.



The business has grown quickly and profits have also grown rapidly over the last two years. Sally wants to continue to expand the business and increase the sales of different suits to add to her current range of medium-priced suits. There is a lot of competition for medium-priced suits and the market is not growing. She has identified two other markets for suits, both of which have increasing demand. However, she is unsure which option to choose.

- Option 1: She can start selling expensive suits that are hand-made and of high-quality material. These suits would be made to measure for each customer and individually designed. The market for these suits is a niche market. She would need to employ more skilled workers.
- Option 2: She can start selling low-priced suits to the mass market. However, to enter this market Sally will need to invest in machinery to produce suits on a large scale. She could gain from economies of scale which would be an advantage.

Sally currently uses batch production. However, if she decides to follow Option 1 she will use job production and if she follows Option 2 she will use flow production.

Appendix 1: added value for Premium Suits



Added value for Premium Suits

(continued)

- 1 a) As Premium Suits grows larger it could gain from economies of scale. Identify and explain **two** economies of scale the business might benefit from as it grows. [8]
- b) Quality is important to Sally. Consider the advantages and disadvantages of quality control and quality assurance. Recommend which method Sally should use to ensure quality suits are produced. Justify your answer. [12]
- 2 a) Explain the main features of job production for Option 1 and the main features of flow production for Option 2. [8]
- b) Sally believes that new machinery will have advantages for the business but no disadvantages. Do you agree with Sally? Justify your answer. [12]

Optional questions

- 3 a) Appendix 1 shows added value for Sally's business. Identify and explain **two** ways Sally could increase the added value for her suits. [8]
- b) Sally says that Option 1 would require a different marketing mix to Option 2. How do you think each of the elements of the marketing mix will be different for the two products in Option 1 and Option 2? Justify your answer. [12]
- Product
 - Price
 - Promotion
 - Place

Section

5

Financial information and financial decisions

Chapters

- 21 Business finance: needs and sources
- 22 Cash flow forecasting and working capital
- 23 Income statements
- 24 Balance sheets
- 25 Analysis of accounts

-70.02 (-1.7%)

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TOP 10 S&P/ASX200
LOSSES

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| AQP | AQUA PLAT | 15 |
| DTE | DARTENERGY | |
| CPL | COALSPUR | |
| AUT | AURORA OIL | |
| BKN | BRADKEN | |
| | CAMPB.BROS | |
| | ATHURST | |
| | ERGY | |

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| \$0.96 | ▼ | -0.08 | -7.69% |
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| \$0.41 | ▼ | -0.03 | -6.95% |
| \$0.72 | ▼ | -0.05 | -6.95% |
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This chapter will explain:

- why businesses need finance
- the differences between short- and long-term finance
- the importance of micro-finance in developing economies
- the different sources of finance available to business
- how managers choose between different sources.

What do Finance departments do?

Finance departments fulfil a very important role in business. They have the following responsibilities:

- recording all financial transactions, such as payments and sales revenue
- preparing final accounts
- producing accounting information for managers
- forecasting cash flows
- making important financial decisions e.g. which source of capital to use for different purposes within the business.

Why do businesses need finance?

What is finance? Finance is money. We all need money to purchase the goods and services we require – everyday goods, like food, but also more expensive items such as a house or car. Businesses need finance too – and this is often called ‘capital’.

Without finance they could not pay wages, buy materials or pay for assets. Here are three examples of why capital is needed:

- starting up a business
- expansion of an existing business
- increasing working capital.

Starting up a business

When an individual plans to start their own business, they should consider all of the buildings, land and equipment they will need to buy in order to start trading. These are usually called fixed assets (see Chapter 24) and nearly all new businesses will need to purchase some of these. In addition, the owner of the firm will need to obtain finance to purchase other assets such as inventories before goods can be sold to the first customers. The finance needed to launch a new business is often called **start-up capital**.

Expanding an existing business

The owners of a successful business will often take a decision to expand it in order to increase profits.

Additional fixed assets could be purchased – such as buildings and machinery. Another business could be purchased through a takeover.

Definitions to learn

Start-up capital is the finance needed by a new business to pay for essential fixed and current assets before it can begin trading.

Definitions to learn

Working capital is the finance needed by a business to pay its day-to-day costs.

Capital expenditure is money spent on fixed assets which will last for more than one year.

Revenue expenditure is money spent on day-to-day expenses which do not involve the purchase of a long-term asset, for example wages or rent.

Other types of expansion include developing new products to reach new markets. This form of growth could require substantial amounts of finance for research and development.

Additional working capital

Working capital is often described as the 'life blood' of a business. It is finance that is constantly needed by firms to pay for all their day-to-day activities. They have to pay wages, pay for raw materials, pay electricity bills and so on. The money available to them to do this is known as the firm's working capital. It is vital to a business to have sufficient working capital to meet all its requirements. Many businesses have stopped trading, not because they were unprofitable, but because they suffered from shortages of working capital.

So, the third major business need for finance is often to raise additional working capital.

In all three cases above, businesses may need finance to pay for either **capital expenditure** or **revenue expenditure**. It is important to understand the difference.

- Capital expenditure is money spent on fixed assets such as buildings which will last for more than one year. These assets are needed at the start of a business and as it expands.
- Revenue expenditure is money spent on day-to-day expenses, for example wages or rent.

Revision summary: financial needs of business**Activity 21.1**

Look at the list below of expenses for a sports centre. Copy out the table and tick whether you consider each is either revenue expenditure or capital expenditure.

| | Revenue expenditure | Capital expenditure |
|--------------------------|---------------------|---------------------|
| Purchase of building | | |
| Water rates | | |
| Staff wages | | |
| Office computer | | |
| Gym equipment | | |
| Maintenance of equipment | | |

Activity 21.2: Paul's taxi business

Paul has decided to leave his job to set up his own taxi business.

- Explain to Paul why he will need finance for his new business.
 - Make a list of the likely set-up costs of this business for its first month of operation.
 - Indicate which of these costs are revenue expenditure and which are capital expenditure.
- Explain your answer.

Definitions to learn

Internal finance is obtained from within the business itself.

External finance is obtained from sources outside of and separate from the business.

Sources of finance

There are many different sources of finance available. It is common to split them up, or classify them, into different groups. The two most common ways of doing this are:

- **internal** or **external** sources of finance
- short-term or long-term sources of finance.

Internal finance

The most common examples of internal finance are as follows.

Retained profit

This is profit kept in the business after the owners have taken their share of the profits. It is often called ploughed-back profit, and has the following advantages.

- Retained profit does not have to be repaid unlike, for example, a loan.
- There is no interest to pay – the capital is raised from within the business.

There are disadvantages too.

- A new business will not have any retained profits.
- Many small firms' profits might be too low to finance the expansion needed.
- Keeping more profits in the business reduces payments to owners, for example dividends to shareholders.

Sale of existing assets

Existing assets that could be sold are those items of value which are no longer required by the business, for example, redundant buildings or surplus equipment.

- This makes better use of the capital tied up in the business.
- It does not increase the debts of the business.

However:

- It may take some time to sell these assets and the amount raised is never certain until the asset is sold.
- This source of finance is not available for new businesses as they have no surplus assets to sell.

Sale of inventories to reduce inventory levels

- This reduces the opportunity cost and storage cost of high inventory levels.

However:

- It must be done carefully to avoid disappointing customers if not enough goods are kept as inventory.

Owners' savings

A sole trader or members of a partnership can put more of their savings into their unincorporated businesses. As we saw in Chapter 4, the owners of these firms are not separate from their businesses and therefore such finance is called internal.

Advantages include:

- It should be available to the firm quickly.
- No interest is paid.

However:

- Savings may be too low.
- It increases the risk taken by the owners.

Revision summary: internal sources of finance



Activity 21.3: Paul asks for your help

Paul needs advice on sources of finance before going ahead with his business plan (Activity 21.2). Explain to him why:

- Retained profits are not, to start with, a possible source of finance.
- His savings will be likely to be an important source of funds.
- Selling off inventories is never likely to be an available source of finance to his taxi business.

Tips for success

Remember that only limited companies can raise capital by selling shares – and that only public limited companies can offer shares for sale to the public.

External finance

The most common forms of external finance are as follows.

Issue of shares

This source of finance is only possible for limited companies.

- This is a permanent source of capital which would not have to be repaid to shareholders.
- No interest has to be paid.

However:

- Dividends are paid after tax, whereas interest on loans is paid before tax is deducted.
- Dividends will be expected by the shareholders.
- The ownership of the company could change hands if many shares are sold.

Bank loans

A bank loan is a sum of money obtained from a bank which must be repaid and on which interest is payable.

- These are usually quick to arrange.
- They can be for varying lengths of time.
- Large companies are often offered low rates of interest by banks if they borrow large sums.

However:

- A bank loan will have to be repaid eventually and interest must be paid.
- Security or collateral is usually required. This means the bank may insist that it has the right to sell some of the firm's property if it fails to pay interest or does not repay the loan. A sole trader may have to put his or her own house up as security on a bank loan.

Selling debentures

These are long-term loan certificates issued by limited companies.

- Debentures can be used to raise very long-term finance, for example, 25 years.

However:

- As with loans, these must be repaid and interest must be paid.

Factoring of debts

A debtor is a customer who owes a firm money for goods bought. Debt factors are specialist agencies that 'buy' the claims on debtors of firms for immediate cash. For example, a debt factor may offer 90 per cent of an existing debt. The debtor will then pay the factor and the 10 per cent represents the factor's profit – when the factor collects payment from the debtor.

- Immediate cash is made available to the business.
- The risk of collecting the debt becomes the factor's and not the business's.

However:

- The firm does not receive 100 per cent of the value of its debts.

Grants and subsidies from outside agencies

Outside agencies include, for example, the government.

- These grants and subsidies usually do not have to be repaid.

However:

- They are often given with 'strings attached', for example, the firm must locate in a particular area.

Micro-finance

In many low-income developing countries, traditional commercial banks have been very unwilling to lend to poor people – even if they wanted the finance to set up an enterprise. Banks did not lend because:

- The size of the loans required by poor customers – perhaps a few dollars – meant that the bank could not make a profit from the loans.
- The poorer groups in society often have no asset to act as ‘security’ for loans – banks are usually not prepared to take risks by lending without some form of security (assets they can sell if the borrower cannot repay).

Definitions to learn

Micro-finance is providing financial services – including small loans – to poor people not served by traditional banks.

Specialist institutions have been set up in most developing countries to meet the financial needs of poor people – especially poor entrepreneurs. The most famous of these is the Grameen Bank in Bangladesh. These institutions, including postal savings banks, finance cooperatives, credit unions and development banks, focus on lending small sums of money to people – hence the term **micro-finance** or micro-credit.

Case study – ‘micro-finance changed my life’

Parveen Bajji lives in Pakistan. She has nine children and she used to ask neighbours for food to help feed them all. All it took to turn Parveen’s life round was a \$70 loan from the Kashf Foundation. The loan allowed her to start a jewellery making business which quickly took off. Now she also owns a restaurant and a catering business that employs eight people. She has repaid the original loan and interest on it. She is able to pay for her children to go to high school and college. ‘Micro-finance has changed my life’ Parveen says.

Activity 21.4

Read the case study above.

- Why do you think that traditional banks would not lend Parveen money for her business?
- Explain the benefits that this example of micro-finance has given to Parveen, her family and her country.

Revision summary: external sources of finance



Activity 21.5: Paul’s business expands

Paul’s taxi business has now been operating for two years. He wants to expand by buying another taxi and employing two drivers on a shift system.

- Explain to Paul the benefits of using the business profits to buy the taxi rather than taking out a bank loan.
- When would you advise Paul to take out a bank loan to expand his business?

Short-term and long-term finance

Short-term finance

This provides the working capital needed by businesses for day-to-day operations. Shortages of cash in the short term can be overcome in three main ways.

Overdrafts

These are arranged by a bank.

- The bank gives the business the right to ‘overdraw’ its bank account (that is, spend more money than is currently in the account).
- The firm could use this finance to pay wages or suppliers but, obviously, it cannot do this indefinitely.
- The overdraft will vary each month with the needs of the business – it is said to be a ‘flexible’ form of borrowing.
- Interest will be paid only on the amount overdrawn.
- Overdrafts can turn out to be cheaper than loans in the short term.

However:

- Interest rates are variable, unlike most loans which have fixed interest rates.
- The bank can ask for the overdraft to be repaid at very short notice.

Trade credit

This is when a business delays paying its suppliers, which leaves the business in a better cash position.

- It is almost an interest-free loan to the business for the length of time that payment is delayed for.

However:

- The supplier may refuse to give discounts or even refuse to supply any more goods if payment is not made quickly.

Factoring of debts

See page 261 under ‘External finance’.

Long-term finance

This is finance which is available for more than a year – and sometimes for very many years. Usually this money would be used to purchase long-term fixed assets, to update or expand the business or to finance a takeover of another firm. The main sources of long-term finance are as follows.

Bank loans

These are payable over a fixed period of time. The advantages and disadvantages of these have already been considered under ‘External finance’.

Hire purchase

This allows a business to buy a fixed asset over a long period of time with monthly payments which include an interest charge.

- The firm does not have to find a large cash sum to purchase the asset.

However:

- A cash deposit is paid at the start of the period.
- Interest payments can be quite high.

Leasing

Leasing an asset allows the firm to use an asset but it does not have to purchase it. Monthly leasing payments are made. The business could decide to purchase the asset at the end of the leasing period. Some businesses decide to sell off some fixed assets for cash and lease them back from a leasing company. This is called sale and leaseback.

- The firm does not have to find a large cash sum to purchase the asset to start with.
- The care and maintenance of the asset are carried out by the leasing company.

However:

- The total cost of the leasing charges will be higher than purchasing the asset.

Issue of shares

As we have seen already, this option is available only to limited companies. (See Chapter 4 for details of how sole traders and partnerships can convert to limited company status.) Shares are often referred to as equities – therefore the sale of shares is sometimes called equity finance.

Public limited companies have the ability to sell a large number of shares to the general public. These new issues, as they are called, can raise very large sums of money but can be expensive to organise and advertise. A rights issue of new shares is a very common way for public limited companies to raise additional capital. This gives existing shareholders the right to buy new shares in proportion to their current holding. This avoids the problem of new shareholders changing the balance of ownership.

See page 261 for the advantages and disadvantages of selling shares to raise finance.

Long-term loans or debt finance

Loans differ from share capital in the following ways:

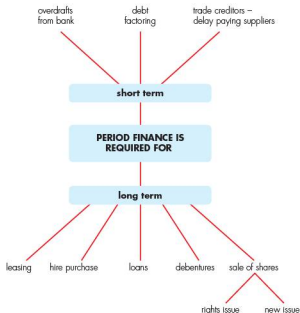
- Loan interest is paid before tax and is an expense.
- Loan interest must be paid every year but dividends do not have to be paid if, for example, the firm has made a loss.
- Loans must be repaid, as they are not permanent capital.
- Loans are often 'secured' against particular assets.

The advantages and disadvantages of loans have already been mentioned under 'External finance'.

Debentures

See page 262 under 'External finance'.

Revision summary: over what period of time is the finance required?



Activity 21.6

Consider all of the following sources of finance. Are they short-term or long-term sources of finance? Copy out the table and tick the relevant column for each source.

| Source of finance | Short-term | Long-term |
|---------------------|------------|-----------|
| Overdraft | | |
| Debentures | | |
| Issue of shares | | |
| Four-year bank loan | | |
| Trade credit | | |
| Hire purchase | | |

Sources of finance: how business makes the choice

We now know the main sources of finance available to firms. What factors do managers consider before deciding where to obtain finance from?

Purpose and time period

What is the finance to be spent on? Is it to be used to pay for fixed assets or is it needed to pay for a short-term cash flow crisis?

The general rule is to match the source of finance to the use that will be made of it.

- If the use is long term, for example the purchase of a fixed asset, the source should be long term.
- If the use is short term, for example the purchase of additional inventories to cover a busy period, the source should be short term.

Think about the disadvantages of buying additional inventories, which will only be needed for a few months, with a long-term bank loan. Can you see why this would be unwise? What source of finance would be suitable for this?

Amount needed

Different sources will be used depending on the amount of money needed. A company would not go to the expense of arranging a new share issue if only \$5000 of capital was needed for a short time period.

Legal form and size

Companies, especially public limited companies, have a greater choice of sources of finance. Issuing shares or debentures is not an option for sole traders and partnerships. These businesses, if they have plans to expand, may have to depend on the savings of their owners – personal capital. They also often have the disadvantage of having to pay higher interest rates to banks for loans than large and well-established companies.

Case study example – choosing the right source of finance

Company A sells fashion clothing. It needs \$15 000 to decorate its shop. A new issue of shares would be the wrong choice. This is because the issue of shares is complicated, expensive to arrange and would take a long time – the firm wants the shop decorated now!

Company B owns three restaurants. It plans to take over another restaurant company and offers \$5 million. Company B already has a large bank loan.

Activity 21.7

Read the case study above.

- a) Advise Company A on the sources of finance that would be suitable.
- b) Advise Company B on the sources of finance that would be suitable.
- c) In each case, which source of finance would be the most suitable to use? Explain why you would choose this source rather than the other sources.
- d) In each case, explain what other information would have been useful before giving your advice.

Control

Owners of businesses may lose control of that business if they ask other people to invest in their firm. Owners may have to decide: what is more important, expanding the business or keeping control of it?

Risk and gearing – does the business already have loans?

An important point about loan capital is that it will raise the gearing of the business – and this is a common measure of risk that the managers are taking. The gearing of a business measures the proportion of total capital raised from long-term loans. If this proportion is very high – say more than 50 per cent – the business is said to be highly geared. This is said to be a risky way of financing a business.

This is risky because interest must be paid on the loans whether the business is making profits or not. When interest rates are high and company profits are low, the firm may not be able to pay all of the interest. The future of the business will be at risk. Therefore, banks are usually reluctant to lend to highly geared businesses which may have to use other sources of finance.

Tips for success

'Which is the best source of finance for this business?' is a very common question. Be prepared to analyse the advantages and disadvantages of the main sources of capital – and give a justified recommendation.

Case study example

- A sole trader could take on a partner to bring in extra capital – but could that partner start to take important decisions without the original owner's permission?
 - The directors of a private limited company could decide to 'go public' and sell shares to the public. This could raise very large sums of money for the business but would the new shareholders own a controlling interest in the business?
 - An existing plc could arrange a new issue of shares, but could these be bought by just one or two other companies who may put in a takeover bid?
- These problems could all be overcome by using loan finance instead.

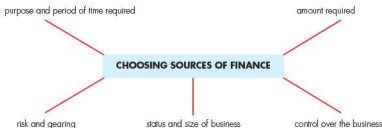
Activity 21.8

Read the case study above.

- a) Would you advise each of these three businesses to use loan capital instead of using the sources of finance outlined above? Explain your answer.
- b) Consider all of these following reasons for a private limited company needing finance. Copy out the table below and, for each type of need, fill in the gaps with:
 - i) what you consider could be the most suitable source of finance
 - ii) the reason for your choice.

| Need for finance | Most suitable source | Reason for choice |
|---|----------------------|-------------------|
| Planned takeover of another business | | |
| Temporary increase in inventories over the summer | | |
| Purchase of new car for the Chief Executive | | |
| Research and development of new product – to come on the market in four years' time | | |
| Cost of building modern factory requiring much less land than the present one | | |

Revision summary: choosing sources of finance – factors involved in the decision



Activity 21.9: Joe's dilemma

Joe Dagglio has \$15 000 in savings. He wants to buy shares in public limited companies because he has heard that he could earn dividends and make a capital gain if the shares rise in price. He has received details of a plc that is arranging a new issue of shares. The company wishes to expand. He makes a note of the following information.

- The current share price is \$5 but it has been as high as \$7.
 - The average value of shares on the Stock Exchange has risen over the last year.
 - The gearing ratio of the company is 55 per cent.
 - Interest rates are likely to rise in the next month or so.
 - The company is offering high dividends to its existing shareholders.
- a) Considering all of the risks and possible gains, advise Joe whether he should buy these shares or not.
 - b) What other information would you find helpful in advising Joe?

Will banks lend and shareholders invest?

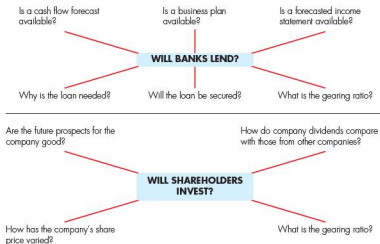
A business can never be sure of being able to raise finance. Banks often refuse to lend to businesses – and shareholders may be reluctant to buy more shares. A business owner, especially of a new start-up business, will increase the chances of obtaining loan finance if the following is available:

- A cash flow forecast which shows why the finance is needed and how it will be used.
- An income statement – for the last time period – and a forecast one for the next. These should show the chances of the business making a profit in future.
- Details of existing loans and sources of finance being used.
- Evidence that 'security' is available to reduce the bank's risk if it lends.
- A business plan to explain clearly what the business hopes to achieve in the future and why the finance is important to these plans.

Shareholders are most likely to buy additional shares when:

- the company's share price has been increasing
- dividends are high – or profits are rising so dividends might increase in the future
- other companies do not seem such a good investment
- the company has a good reputation and has plans for future growth.

Revision summary: finance from banks and shareholders



International business in focus: Godrej Properties

Indian property developing company Godrej Properties successfully raised over US\$90 million from the sale of new shares. The founders of this Mumbai based company owned nearly 84 per cent of the company before the share sale – but only 73 per cent once the shares had been sold. The Indian stock market has seen rising share prices this year and this helped to encourage investors to buy these new shares in Godrej Properties.

The company is expected to use the finance raised to reduce its bank loans and to buy more land for the long-term development of further properties.

Discussion points

- Explain whether Godrej Properties raised internal finance or external finance from the sale of shares.
- Why do you think shareholders were so keen to buy these new shares?
- Explain why the company wanted to reduce its bank loans.



Long-term finance is needed to pay for these building projects

Exam-style questions – Paper 1

- 1 Michelle lost her job when the sugar factory closed. She wanted to start her own business making and repairing clothes. All the main banks refused Michelle's request for a \$100 loan even though she had a business plan. Finally, a development bank specialising in micro-finance agreed to lend her the capital she needed. That was three years ago – she now employs three other people and is planning further expansion of her business.
- What is meant by 'micro-finance'? [2]
 - Identify **two** reasons why Michelle needed \$100 to start her business. [2]
 - Identify and explain **two** likely reasons why the high street banks turned down Michelle's request for a loan. [4]
 - Michelle now wants to expand her business further. Identify and explain **two** benefits of using internal sources of finance to pay for this. [6]
 - Ten years after setting up her business, Michelle converted it into a public limited company to raise finance for business expansion. Do you think she was right to do this? Justify your answer. [6]
- 2 Akram owns a small farm. The income of the business varies greatly during the year. The farm makes a small profit but Akram is ambitious. He wants to take over a neighbour's farm and increase the range of crops he sells. He thinks that he needs long-term finance and plans to take out a bank loan to pay for the takeover. He has already borrowed money to buy a new tractor. A friend has advised him to form a company and sell shares.
- What is meant by 'long-term finance'? [2]
 - Identify **two** types of short-term finance Akram could use when farm income is low. [2]
 - Identify and explain **two** forms of internal finance Akram could have used to buy the tractor. [4]
 - Identify and explain **two** pieces of information a bank would look at before granting a loan to Akram. [6]
 - Do you think Akram should raise finance for the takeover by forming a company and selling shares? Justify your answer. [6]

Revision checklist

In this chapter you have learned to:

- recognise the different reasons why businesses need finance
- identify sources of finance as being either internal or external and also by the period of time for which they are available
- analyse and compare the advantages and disadvantages of different sources of finance
- analyse a firm's need for funds and make a reasoned choice between the different sources of finance available
- make decisions on whether finance should be provided to a business from the viewpoint of shareholders, banks and other institutions.

NOW – test your understanding with the revision questions on the CD-ROM.

Cash flow forecasting and working capital

This chapter will explain:

- the importance of cash flow to business operations
- how a cash flow forecast is constructed and how it can be amended
- how firms can run short of cash and the likely consequences of this
- how a short-term cash flow problem can be overcome
- the importance of working capital.

Definitions to learn

The **cash flow** of a business is the cash inflows and outflows over a period of time.
Cash inflows are the sums of money received by a business during a period of time.
Cash outflows are the sums of money paid out by a business during a period of time.

Why cash is important to a business

Cash is a liquid asset. This means that it is immediately available for spending on goods and services.

Do you ever run out of cash? Have you ever been unable to pay for goods which you need at one particular time because you did not have enough cash? Have you ever borrowed money or incurred bills which you cannot immediately pay? If you answered 'yes' to any of these questions, you have already experienced a **cash flow** problem! In business terms, cash flow means the flow of money into and out of a business over a certain time period.

If a business has too little cash – or even runs out of it completely – it will face major problems:

- unable to pay workers, suppliers, landlord, government
- production of goods and services will stop – workers will not work for nothing and suppliers will not supply if they are not paid
- the business may be forced into 'liquidation' – selling up everything it owns to pay its debts.

What is meant by cash flows?

How can cash flow into a business (**cash inflow**)? Here are five of the most common ways:

- the sale of products for cash
- payments made by debtors – debtors are customers who have already purchased products from the business but did not pay for them at the time
- borrowing money from an external source – this will lead to cash flowing into the business (it will have to be repaid eventually)
- the sale of assets of the business, for example unwanted property
- investors – for example shareholders in the case of companies – putting more money into the business.

How can cash flow out of a business (**cash outflow**)? Here are five of the most common ways:

- purchasing goods or materials for cash
- paying wages, salaries and other expenses in cash

- purchasing fixed assets
- repaying loans
- by paying creditors of the business – other firms who supplied items to the business but who were not paid immediately.

Activity 22.1: Cash inflows or outflows?

Copy the table below. For each of the following transactions, tick the correct column to indicate whether it represents a cash inflow or a cash outflow for Good Hope Enterprises Ltd.

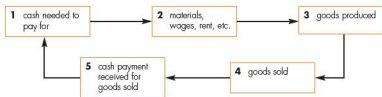
| Transaction | Cash inflow | Cash outflow |
|--|-------------|--------------|
| Purchase of new computer for cash | | |
| Sale of goods to customers – no credit given | | |
| Interest paid on bank loan | | |
| Wages paid to employees | | |
| Debtors pay their bills | | |
| Additional shares are sold to shareholders | | |
| Creditors/suppliers are paid | | |
| Bank overdraft is paid off | | |

Cash flow cycle

The following diagram will help to explain the link between some of the inflows and outflows mentioned above – the **cash flow cycle**. It explains why cash paid out is not returned immediately to the business.

Definitions to learn

A **cash flow cycle** shows the stages between paying out cash for labour, materials, etc. and receiving cash from the sale of goods.



The cash flow cycle

The diagram shows how cash is needed (1) to pay for essential materials and other costs (2) required to produce the product. Time is needed to produce the products (3) before they can be sold to customers (4). If these customers receive credit, they will not have to pay straightaway. When they do pay for the goods in cash (5), this money will be needed (1) to pay for buying further materials, etc. (2) and so the cycle continues.

The longer the time taken to complete these stages, the greater will be the firm's need for working capital (see below) and cash.

The diagram also helps us to understand the importance of planning for cash flows. What would happen if:

- A business did not have enough cash at stage 1? Not enough materials and other requirements could be purchased and so output and sales would fall.
- A business insisted on its customer paying cash at stage 4 because the business was short of money? It might lose the customer to a competitor who could offer credit.
- A business had insufficient cash to pay its bills such as rent and electricity? It would be in a liquidity crisis and it might be forced out of business by its creditors.

These three examples illustrate the need for managers to plan ahead for their cash needs so that the business is not put at risk in these ways.

What cash flow is not!

Cash flow is not the same as **profit**. This is an important distinction.

Definitions to learn

Profit is the surplus after total costs have been subtracted from sales revenue.

Case study – cash is not same as profit!

Good Hope Enterprises Ltd records the following transactions over the month of June:

| | | |
|-------------------------|----------|---------------------------------------|
| Goods sold to customers | \$40 000 | (50% cash; 50% on one month's credit) |
| Costs of goods sold | \$15 000 | (paid for in cash) |

- What was the gross profit in June?
Sales revenue – cost of goods sold = \$25 000
- Assuming the business started the month with no cash, how much cash did it have at the end of June? (Ignore any other transactions.)
Net cash flow = cash inflow – cash outflow
\$20 000 (cash sales) – \$15 000 = \$5000

There is a clear difference between the profit made by Good Hope Enterprises Ltd and the cash flow over the same period.

Q. Why is the cash figure lower than the gross profit?

A. Because, although all goods have been sold, cash payment has been received for only half of them. The customers buying the goods on credit will pay cash in later months.

This important example leads to further questions:

- Can profitable businesses run out of cash? Yes – and this is a major reason for businesses failing. It is called *insolvency*.
- How is this possible? In a number of ways:
 - allowing customers too long a credit period, perhaps to encourage sales
 - purchasing too many fixed assets at once
 - expanding too quickly and keeping a high inventory level. This means that cash is used to pay for higher inventory levels. This is often called *overtrading*.

Case study example

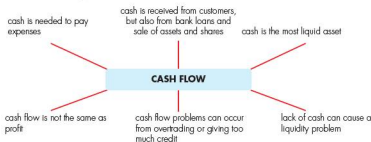
A business records the following transactions for one month:

| | |
|------------------------------|--|
| Sales of goods | \$45 000 (50% for cash; 50% on one month's credit) |
| Materials purchased and used | \$12 000 (all paid in cash during the month) |

Assume no other transactions.

Activity 22.2

- Calculate the gross profit made by the business in this month.
- Calculate the cash held by the business at the end of this month (assume they had no cash at the start of the month).
- Explain why the answers to a) and b) are different.

Revision summary: cash flow**Cash flow forecasts**

We have seen how important cash is to any business. Without sufficient cash to pay bills and repay loans, a business may be forced to stop trading by its creditors and banks. It is therefore very important indeed for the manager of a business to know what cash will be available month by month. A **cash flow forecast** can be used to tell the manager:

- how much cash is available for paying bills, repaying loans or for buying fixed assets
- how much cash the bank might need to lend to the business in order to avoid insolvency
- whether the business is holding too much cash which could be put to a more profitable use.

Managers use cash flow forecasts to help them find out the future cash position of their business.

Uses of cash flow forecasts

Cash flow forecasts are useful in the following situations:

Definitions to learn

A **cash flow forecast** is an estimate of future cash inflows and outflows of a business, usually on a month-by-month basis. This then shows the expected cash balance at the end of each month.

- starting up a business
- running an existing business
- keeping the bank manager informed
- managing cash flow.

Definitions to learn

Opening cash (or bank) balance is the amount of cash held by the business at the start of the month.

Net cash flow is the difference, each month, between inflows and outflows.

Closing cash (or bank) balance is the amount of cash held by the business at the end of each month. This becomes next month's opening cash balance.

Case study example

Cash flow forecast – Good Hope Enterprises Ltd. January to March 2014 (\$). Figures in brackets are negative.

| | January | February | March |
|--------------------------------|---------|----------|--------|
| Cash inflows (A) | 35 000 | 45 000 | 50 000 |
| Cash outflows (B) | 30 000 | 65 000 | 40 000 |
| Opening bank balance (C) | 10 000 | 15 000 | (5000) |
| NET CASH FLOW (D) (= A – B) | 5000 | (20 000) | 10 000 |
| CLOSING BANK BALANCE (= C + D) | 15 000 | (5000) | 5000 |

Note the following points:

- a positive **net cash flow** will increase the closing bank balance
- a negative net cash flow (as in February) will reduce the bank balance
- each **closing bank balance** becomes the **opening bank balance** for the next month
- the bank account will become overdrawn in February.

Starting up a business

When planning to start a business, the owner will need to know how much cash will be needed in the first few months of operation. This is a very expensive time for new businesses as premises have to be purchased or rented, machinery must be purchased or hired, inventory must be built up and advertising and promotion costs will be necessary to make consumers aware of the product or service. Many new businesses fail because owners do not realise how much cash is needed in the first few crucial months. A cash flow forecast should help to avoid these problems.

Keeping the bank manager informed

Banks provide loans to businesses. However, before bank managers will lend any money, they need to see the firm's cash flow forecast. This is particularly true of a new business, but also for an existing one. The bank manager will need to see how big a loan or overdraft is needed, when it is needed, how long the finance is needed for and when it might be repaid.

It is very rare for a bank to lend to a business unless a cash flow forecast is produced which shows these factors.

Managing an existing business

As seen from earlier examples, it is not just newly formed businesses which need to forecast cash flows. Any business can run out of cash and require an overdraft, perhaps because of an expensive fixed asset being bought or a fall in sales. Borrowing money needs to be planned in advance so that the lowest rates of interest can be arranged. Telling the bank today that a loan is needed tomorrow could lead to the bank either refusing the loan – because of poor business planning – or charging high

Tips for success

There can be slight variations in the way businesses lay out their cash flow forecasts. The examples used in this chapter will be the same, or very similar to, ones used in examinations.

rates of interest. The bank will know that the business has little alternative but to pay these interest rates. If the business exceeds the overdraft limit from the bank without informing the bank manager first, the bank could insist that the overdraft is repaid immediately and this could force the business to close.

Managing cash flow

Too much cash held in the bank account of a business means that this capital could be better used in other areas of the business. If it seems that the business is likely to have a very high bank balance, the accountant could decide to pay off loans to help to reduce interest charges. Another option would be to pay creditors quickly to take advantage of possible discounts. These are examples of actively managing the cash flow of a business.

Activity 22.3: Using a cash flow forecast

Cash flow forecast for Sierra Promotions Co. January to April 2014 (\$). Figures in brackets are negative.

| | January | February | March | April |
|----------------------------|---------------|---------------|---------------|---------------|
| Cash inflows: | | | | |
| Cash sales | 15 000 | 15 000 | 20 000 | 25 000 |
| Payments from debtors | 5000 | 5000 | 7000 | 8000 |
| Total cash inflows | 20 000 | 20 000 | 27 000 | 33 000 |
| Cash outflows: | | | | |
| Materials and wages | 3000 | 3000 | 5000 | 7000 |
| Rent and other expenses | 15 000 | 15 000 | 25 000 | 15 000 |
| Total cash outflows | 18 000 | 18 000 | 30 000 | z |
| Opening bank balance | 3000 | 5000 | 7000 | 4000 |
| Net cash flow | 2000 | x | (3000) | 11 000 |
| Closing bank balance | 5000 | 7000 | y | 15 000 |

- Calculate values for x, y and z.
- Suggest one reason why 'materials and wages' are forecast to be so much higher in March and April than in the previous months.
- In April, cash sales are now expected to be 10 per cent higher than shown. Material and wages are expected to be 20 per cent higher than forecast. Amend the cash flow forecast for April and calculate the new closing cash balance.

Case study example

The manager of Capri Motors Ltd wants to plan the cash flows of the business over the next four months. She asks for your help in making a cash flow forecast. She provides you with the following information.

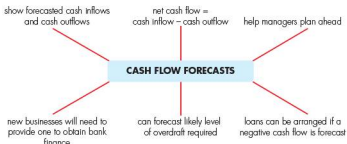
- Forecasted sales are: January \$22 000; February \$25 000; March \$20 000; April \$22 000.
- Customers always pay cash.
- Materials are purchased each month and are paid for in cash. The materials used each month are 50 per cent of sales revenue for that month.
- Other cash expenses (wages, rent, insurance, etc.) are forecast to be: January \$4000; February \$13 000; March \$15 000; April \$15 000.
- The opening cash balance in January is \$2000.

Activity 22.4: Creating a cash flow forecast

Read the case study on page 277.

- Explain to the manager the importance of a cash flow forecast.
- Using the same structure as in the examples above, draw up a cash flow forecast for this business over the four months from January to April.
- What do you notice about the closing bank balance in April? What action could the manager of Capri Motors Ltd take now that she is aware of this problem?

Revision summary: cash flow forecasts



How can cash flow problems be overcome?

There are several ways in which a short-term cash flow problem could be overcome. These are explained below – and the limitations of each method are outlined too.

| Method of overcoming cash flow problem | How it works | Limitations |
|---|--|---|
| Increasing bank loans | Bank loans will inject more cash into the business. | Interest must be paid – this will reduce profits. The loans will have to be repaid eventually – a cash outflow. |
| Delaying payments to suppliers | Cash outflows will decrease in the short term. | Suppliers could refuse to supply. Supplier could offer lower discounts for late payments. |
| Asking debtors to pay more quickly – or insisting on only 'cash sales' | Cash inflows will increase in the short term. | Customers may take their custom to another business that still offers them time to pay – i.e. trade credit. |
| Delay or cancel purchases of capital equipment | Cash outflows for purchase of equipment will decrease. | The long-term efficiency of the business could decrease without up-to-date equipment. |

In the longer term, a business with cash flow difficulties will have to take other decisions to solve the problem. These could include:

- Attracting new investors, for example by selling more company shares – but will this affect ownership of the business?
- Cutting costs and increasing efficiency – but will this be popular with employees and could product quality be affected?
- Developing new products that will attract more customers – this could take a long time and needs cash in the short term to pay for development.

Case study example – Gardener's Green

Manuel Guitano set up in business as a sole trader nine years ago. He called his business Gardener's Green. Manuel designs and looks after the gardens of hotels, offices and large private houses. The business is very busy in the spring, summer and autumn but not very busy in winter. Manuel employs six full-time employees. These employees have been with him for the past four years. Experienced gardeners are not always easy to find. Gardener's Green has a small amount of land with six greenhouses although there is space for more. Gardener's Green grows about 50 per cent of the plants that it supplies to customers. The revenue of the business varies throughout the year, but expenses occur every month.

Look at the cash flow forecast for the next financial year below. There is a cash flow problem. You have been asked by Manuel to consider this problem and make recommendations as to what he can do to solve it.

Cash flow forecast for Gardener's Green 2014/2015. All figures in brackets are negative.

| | Aug. \$ | Sept. \$ | Oct. \$ | Nov. \$ | Dec. \$ | Jan. \$ | Feb. \$ | Mar. \$ | Apr. \$ | May \$ | Jun. \$ | Jul. \$ |
|---------------------------|---------------|---------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|---------------|---------------|---------------|---------------|
| Cash inflows | | | | | | | | | | | | |
| Cash sales | 70 000 | 80 000 | 1000 | 1400 | 200 | 200 | 1000 | 50 000 | 80 000 | 80 000 | 60 000 | 60 000 |
| Cash outflows | | | | | | | | | | | | |
| Wages | 20 000 | 20 000 | 20 000 | 20 000 | 20 000 | 20 000 | 20 000 | 20 000 | 20 000 | 20 000 | 20 000 | 20 000 |
| Plants & trees purchased | 20 000 | 0 | 0 | 0 | 0 | 0 | 0 | 30 000 | 30 000 | 30 000 | 30 000 | 30 000 |
| Seeds & compost | 0 | 6000 | 6000 | 0 | 0 | 6000 | 8000 | 8000 | 7000 | 0 | 0 | 0 |
| Heating & water | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 |
| Bank interest | 0 | 0 | 0 | 0 | 0 | 1018 | 3549 | 4649 | 3150 | 910 | 216 | 0 |
| Business tax on land | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Total cash outflow | 41 100 | 27 100 | 27 100 | 21 100 | 21 100 | 28 118 | 32 649 | 63 749 | 61 250 | 52 010 | 51 316 | 51 100 |
| Opening bank balance | 100 | 29 000 | 81 900 | 55 800 | 36 100 | 15 200 | (12 718) | (44 367) | (58 116) | (39 366) | (11 376) | (2692) |
| Net cash flow | 28 900 | 52 900 | (26 100) | (19 700) | (20 900) | (27 918) | (31 649) | (13 749) | 18 750 | 27 990 | 8684 | 8900 |
| Closing bank balance | 29 000 | 81 900 | 55 800 | 36 100 | 15 200 | (12 718) | (44 367) | (58 116) | (39 366) | (11 376) | (2692) | 6208 |

Activity 22.5

- Why is cash flow forecasting important to managers such as Manuel?
- Who else, apart from Manuel, is likely to be interested in a cash flow forecast for Gardener's Green? Give reasons for your answer.
- Why do some costs stay the same each month? Use examples to explain your answer. Why do some costs vary each month? Use examples to explain your answer.
- Manuel has just been informed that his supplier of plants and trees will raise prices by 10 per cent in July 2015. Explain how the cash flow forecast for Gardener's Green will be affected.
- Manuel wants to improve the cash flow of his business. Suggest three ways to Manuel, of improving the cash flow of Gardener's Green. Explain their advantages and disadvantages. Recommend which way he should choose.

Definitions to learn

Working capital is the capital available to a business in the short term to pay for day-to-day expenses.

The importance of working capital

The term **working capital** refers to the amount of capital which is readily available to a business. That is, working capital is the difference between resources in cash or readily convertible into cash and the short-term debts of the business. After studying Chapter 24, you will understand that:

Working capital = current assets – current liabilities

Working capital is the life-blood of a business. Having enough working capital assists in raising the credit reputation of a business.

No business can run effectively without a sufficient quantity of working capital. It is crucial to retain the right level of working capital.

A business enterprise with ample working capital is always in a position to take advantage of any favourable opportunity either to buy raw materials being offered at a discount or to implement a customer's special order.

Working capital may be held in different forms:

- Cash is needed to pay day-to-day costs and buy inventories.
- The value of a firm's debtors is related to the volume of production and sales. To achieve higher sales there may be a need to offer additional credit facilities.
- The value of inventories is also a significant part of working capital. Not having enough inventories may cause production to stop. On the other hand, a very high inventory level may result in high opportunity costs.

The overall success of a business depends upon its working capital position. So, it should be handled properly because it shows the efficiency and financial strength of company.

International business in focus: dealing with cash flow issues in different ways

Two businesses in different industries have approached potential cash flow problems in different ways. Kodak – formerly the world's biggest supplier of camera film – has since 2003 cut its workforce by 47 000 as demand for traditional film collapsed as a result of the 'digital revolution'. It also obtained a \$950 million loan facility from Citicorp to give it the cash to keep it going.

Kier Group is a huge construction company based in Europe. The end of the property boom after the financial crisis of 2008/2009 meant that construction companies had less work and were having to wait for payment from customers for longer. Kier started to manage its operations to minimise cash outflows. The business has over 80 different suppliers for a typical large building project. Kier now holds no or very low inventories and demands that all of its suppliers deliver goods and equipment on the day they are needed – or very shortly before. This means that valuable cash is not held up in inventories that will not be used for weeks.

**Discussion points**

- Explain how the following had an impact on cash flows:
 - i) technological change for Kodak
 - ii) Ending of the property boom for Kier Group.
- Explain the different ways these businesses tried to resolve a potential cash flow problem.

Exam-style questions – Paper 1

- 1 Bruno manages a hotel. Most of the hotel bedrooms are occupied during the main tourist season, which lasts for seven months. The hotel's main cash outflows are the same each month but food costs and some employee costs increase when there are more tourists. Bruno plans to have the hotel redecorated but he does not know whether the cost of this will mean the hotel exceeds its overdraft limit. The hotel's bank account is overdrawn for several months of each year.
- What is meant by 'cash outflows'? [2]
 - Identify **two** likely cash outflows for Bruno's hotel. [2]
 - Identify and explain **two** effects on Bruno's hotel if he offers hotel guests credit of one month following a stay in the hotel. [4]
 - Identify and explain **two** likely benefits to Bruno of producing a cash flow forecast. [6]
 - Explain the advantages and disadvantages of any **two** ways in which Bruno could improve the cash flow position of the hotel. Which way would you advise him to use? Justify your answer. [6]
- 2 Abbas Manufacturing produces wheels for cars. It holds high inventory levels so that one-off orders from major car manufacturers can be satisfied quickly. The world's big car manufacturers demand long credit periods from their suppliers of three months. Bruno has prepared the following cash flow forecast for the next three months:

| \$000 | July | August | September |
|-----------------------------|------|--------|-----------|
| Cash inflows | | | |
| Cash from debtors' payments | 550 | 475 | 545 |
| Sale of old equipment | 0 | 0 | 50 |
| Total cash in | 550 | 475 | 595 |
| Cash outflows | | | |
| Materials purchased | 160 | 175 | 170 |
| Employee costs | 185 | 185 | 190 |
| New computers | 0 | 145 | 0 |
| Other costs | 155 | 125 | 135 |
| Total cash out | 500 | 630 | 495 |
| Opening bank balance | (75) | (25) | (180) |
| Net cash flow | 50 | (155) | x |
| Closing bank balance | (25) | (180) | y |

- What is meant by 'net cash flow'? [2]
- Identify **two** reasons why Abbas Manufacturing needs high amounts of cash or working capital. [2]
- Calculate the values for x and y in the cash flow forecast. Show your working. [4]

- d) Amend the cash flow forecast for July assuming cash from debtors and material costs are going to be 10 per cent higher than originally forecast. Show your working. [6]
- e) Using the cash flow forecast above, advise Abbas Manufacturing on the best ways for the business to reduce its bank overdraft (negative closing balance). Justify your advice. [6]

Revision checklist

In this chapter you have learned:

- the importance of cash to a business
- what is meant by cash flow, cash inflow and cash outflow
- the difference between the profit made by a business and its cash flow position
- what the cash flow cycle is and how a business might improve its cash flow position
- understand and amend a cash flow forecast
- what working capital means and why it is important to a business.

NOW – test your understanding with the revision questions on the CD-ROM.

This chapter will explain:

- why businesses need to keep accounting records such as income statements
- why profits are not the same as cash
- why profits are important
- the differences between gross, net and retained profit
- what the income statement contains.

What are accounts and why are they necessary?

Definitions to learn

Accounts are the financial records of a firm's transactions.

Accountants are the professionally qualified people who have responsibility for keeping accurate accounts and for producing the final accounts.

Final accounts are produced at the end of the financial year and give details of the profit or loss made over the year and the worth of the business.

Case study example

Shazad Nidal has been in business for ten months. He is a tailor making expensive suits. He operates as a sole trader.

Imagine what could happen to his business if he failed to keep a written record of all financial transactions, such as purchases and sales.

- He could sell goods on credit to customers without keeping a record of the sale. As a result, he might forget that customers still owed him money.
- He might order too many raw materials because no record was kept of previous orders.
- He might pay all of the business costs, for example electricity, raw materials and wages, on the same day and then find out that there was no money in the bank.
- The profits or losses of the business could not be calculated.
- The government tax collector would not be able to check how much tax Shazad owed – a heavy fine could be charged if the tax is not paid.

Without written financial records, the business would soon be in deep trouble.

The financial records of a business are called its **accounts**. They should be kept up to date and with great accuracy – this is the responsibility of the **accountants** working in the Finance department.

At the end of each financial year, the accountant will produce the **final accounts** of the business. These will record the main financial results over the year and the current worth or value of the business.

Limited companies are required by law to publish their final accounts and these are much more detailed than those required from non-company businesses, such as sole traders and partnerships.

Recording accounting transactions

In most businesses, there are so many transactions each year that it would be very time-consuming to record them all by hand in accounting books. This is one reason most organisations now use computers. Computer files store records of all the sales, purchases and other financial transactions made by a firm and the information can be retrieved or printed out when required.

How a profit is made

Profit is an objective for most businesses. In simple terms, profit is calculated by:

Profit = sales revenue – cost of making products.

This simple formula introduces the idea that profit is a ‘surplus’ that remains after business costs have been subtracted. If these costs exceed the sales revenue, then the business has made a loss. The profit formula also suggests that this surplus can be increased by:

- 1 increasing sales revenue by more than costs
- 2 reducing cost of making products
- 3 a combination of 1 and 2.

Why is profit important?

Profit is important to private sector businesses for several reasons:

| Why profit is important | Explanation |
|-------------------------|--|
| Reward for enterprise | Successful entrepreneurs have many important qualities and characteristics and profit gives them a reward for these. |
| Reward for risk taking | Entrepreneurs and other investors take considerable risks when they provide capital to a business – profits reward them for taking these risks by allowing payments to be made (e.g. dividends to shareholders). These payments provide incentives: to business owners to try to make their business even more profitable; to investors to put more capital into profitable businesses. |
| Source of finance | Profits after payments to the owners (retained profits) are a very important source of finance for businesses – this allows for expansion (see Chapter 21). |
| Indicator of success | When some businesses are very profitable, other businesses or new entrepreneurs are given a signal that investment into producing similar goods or services would be profitable. If all businesses in an industry are making losses, this would not be a good signal to set up in that industry! |

In public-sector or state-owned businesses, profit might also be important. The government might set profit as one of the targets to be achieved for these businesses. These surpluses could also be used as a source of finance to develop the state-owned business or make it more efficient.

In social enterprises (see Chapter 4), profit also has an important role to play. Social enterprises cannot usually survive unless they make a surplus from their operations but profit is not their only objective. The managers of social enterprises will want to balance profit making with other aims such as protecting the environment and benefiting disadvantaged groups in society.

Difference between profit and cash

Do you recall from Chapter 22 that profit and cash are not necessarily the same? Re-read page 274.

Q: Why is it important to remember this distinction when looking at a business’s final accounts?

A: Just because a business records a profit does not mean it has plenty of cash. In fact, it could have no cash at all!

Attempt the following activity to confirm that you understand this important point.

Activity 23.1

Copy and complete the following table.

| Business transaction | Profit/loss | Impact on cash |
|--|------------------------------|--|
| a) Sells 5000 items for cash @ \$2. Each item cost the business \$1.50 but it has not yet paid its suppliers | \$2500 (5000 items × \$0.50) | |
| b) Sells 25 000 items on credit @ \$3. Pays cash to suppliers (\$2 per item) | | Outflow of \$50 000 (sales on credit but cash paid for supplies) |
| c) Sells 8000 items for cash @ \$4. Suppliers paid in cash (\$2 per item) | \$16 000 | |

Definitions to learn

An **income statement** is a document that records the income of a business and all costs incurred to earn that income over a period of time (for example one year). It is also known as a profit and loss account. A **gross profit** is made when sales revenue is greater than the cost of goods sold.

The **sales revenue** is the income to a business during a period of time from the sale of goods or services. The **cost of goods sold** is the cost of producing or buying in the goods actually sold by the business during a time period.

Understanding income statements

Income statements (also known as profit and loss accounts) are important business accounts. They indicate to managers, business owners and other account users, whether the business has made a profit or loss over a period of time. This time period is usually one year but income statements could be constructed monthly too.

If the business is making a profit, managers will want to ask themselves:

- Is it higher or lower than last year?
- If lower, why is profit falling?
- Is it higher or lower than other similar businesses?
- If lower, what can we do to become as profitable as other businesses?

If the business is making a loss, managers will want to ask themselves:

- Is this a short- or long-term problem?
- Are other similar businesses also making losses?
- What decisions can we take to turn losses into profits?

You can begin to realise why income statements are so important.

Gross profit

What information do income statements contain? Before we can answer this, we need to consider an important concept known as **gross profit** – which is profit calculated before fixed costs are considered. Here is an example:

If a business bought \$270 000 worth of goods during the year and sold them for \$450 000, the gross profit would be \$180 000.

$$\text{Gross profit} = \text{sales revenue} - \text{cost of goods sold}$$

It is important to note the following.

- Gross profit does not make any allowance for overhead costs or expenses.
- Cost of goods sold is not necessarily the same as the total value of goods bought by the business.

How is this information presented on an income statement?

The following table shows a simple example with some notes to explain each item. It is for a limited company, as these are the only businesses that have to publish their accounts.

| | | |
|----------------------------------|-------|--|
| Income statement for XYZ Limited | | <i>The business/company name should be shown clearly</i> |
| For the year ending 31/10/13 | \$000 | <i>The time period covered by the income statement must be shown</i> |
| Sales revenue | 450 | <i>This is the value of goods sold during the year. For example 900 000 items @ 50 cents each</i> |
| Cost of goods sold | 270 | <i>This is the variable cost (materials and labour for example) of making the goods sold. For example, 900 000 items costing 30 cents each</i> |
| Gross profit | 180 | <i>This is the profit made = \$450 000 – \$270 000</i> |

Definitions to learn

A trading account shows how the gross profit of a business is calculated.

This section of the income statement is often referred to as the **trading account**. It shows the gross profit made from the normal trading activities of the business. Why do you think it is not a complete income statement? There are several important items missing from this example:

- other costs of running the business apart from the variable labour and material costs, for example fixed costs
- taxes on profit paid by the company
- payment of a share of the profits to owners/shareholders.

Case study example

The City Café Co. buys cans of drink from a wholesaler for \$1 each. It sells them for \$2 each. City Café Co. started the year with 200 cans in stock (opening inventories). It bought in 1500 cans. At the end of the year it had 300 left (closing inventories).

- 1 How many cans did the business sell during the year?
- 2 What was the cost to the business of the goods sold?
- 3 What was the gross profit?

The answers to these questions are as follows.

- 1 Add together the opening inventory and the cans bought during the year:
 $200 + 1500 = 1700$ cans.
 The business could have sold 1700 cans during the year. We know that it did not sell this many. How? Because there were closing inventories of 300. Therefore, the business must have sold 1400 cans.
 $\text{Goods sold} = \text{opening inventories} + \text{purchases} - \text{closing inventories}$
- 2 As the goods were all bought by the business for \$1 each, the cost of goods sold was \$1400.
- 3 Remember:
 $\text{Gross profit} = \text{sales revenue} - \text{cost of goods sold}$
 In this example, sales revenue = $\$2 \times 1400$ cans sold = \$2800
 $\text{Gross profit} = \$2800 - \$1400 = \$1400$

Tips for success

You should be able to make suggestions on how a business might increase its gross profit.

Activity 23.2

Copy and complete the following table (all figures in \$).

| Sales revenue | Cost of goods sold | Gross profit |
|---------------|--------------------|--------------|
| a) 3000 | 1500 | |
| b) 25 000 | 16 000 | |
| c) 80 000 | | 20 000 |
| d) | 25 000 | 50 000 |

Activity 23.3

Copy and complete this table.

| Cost per unit | Opening inventories | Purchases of goods | Closing inventories | Cost of goods sold |
|---------------|---------------------|--------------------|---------------------|--------------------|
| a) \$3 | 500 | 3000 | 200 | \$9900 |
| b) \$2 | 1000 | 5000 | 500 | |
| c) \$5 | 100 | 400 | 300 | |
| d) \$1 | 2000 | 60 000 | 2000 | |

Case study example

This is an example of a typical trading account section of an income statement:

ABC Ltd. For year ending 31/3/2013

| | |
|----------------------------------|-----------------|
| Sales revenue | \$55 000 |
| Opening inventories | \$10 000 |
| Purchases | \$25 000 |
| Total inventory available | \$35 000 |
| Less closing inventories | \$12 000 |
| Cost of goods sold | \$23 000 |
| Gross profit | \$32 000 |

It is important to note that in a manufacturing business, rather than a retailing one, the labour costs and production costs directly incurred in making the products sold will also be deducted before arriving at the gross profit total.

The gross profit is not the final profit for the business because all of the other expenses have to be deducted. Costs such as salaries, lighting and rent of the buildings need to be subtracted from gross profit.

Definitions to learn

Net profit is the profit made by a business after all costs have been deducted from sales revenue. It is calculated by subtracting overhead costs from gross profits. **Depreciation** is the fall in the value of a fixed asset over time.

Retained profit is the net profit reinvested back into a company, after deducting tax and payments to owners, such as dividends.

Net profit (also known as 'profit before tax')

Net profit is calculated by deducting all expenses and overheads of the business from gross profit. Unlike gross profit, net profit will also include any non-trading income, such as the rent from an apartment above a shop.

Case study example

Newtown Garden Nursery Ltd. Income statement for year ending 31/3/2013

| | |
|----------------------------------|-----------------|
| Gross profit | \$32 000 |
| Non-trading income | \$5 000 |
| | <u>\$37 000</u> |
| Less expenses: | |
| Wages and salaries | \$12 000 |
| Electricity | \$6 000 |
| Rent | \$3 000 |
| Depreciation | \$5 000 |
| Selling and advertising expenses | \$5 000 |
| | <u>\$31 000</u> |
| Net profit | \$6 000 |

Depreciation is the fall in the value of a fixed asset over time. This is included as an annual expense of the business. For example, a new truck bought by a building firm will fall in value with age and use. Each year, this fall in value or depreciation is recorded as an expense on the income statement.

Retained profit

The **retained profit** is the profit left, or reinvested back into the business, after all payments have been deducted.

The income statement for limited companies will also contain:

- corporation tax paid on the company's net profits
- the dividends paid out to shareholders (in some years, dividends might be zero)
- the retained profits left after these two deductions
- results from the previous year to allow for easy comparisons.

Case study example

Here is a typical income statement for a public limited company (plc). It is in a simplified form to help understanding.

Income statement for Ace Engineering plc for the year ending 31/3/2013

| | 2013 | 2012 |
|-------------------------------------|------------|------------|
| | (\$000) | (\$000) |
| Sales revenue | 1250 | 1300 |
| Cost of sales | <u>900</u> | <u>900</u> |
| Gross profit | 350 | 400 |
| Expenses including interest paid | <u>155</u> | <u>160</u> |
| Net profit | 195 | 240 |
| Corporation tax | <u>35</u> | <u>40</u> |
| Profit after tax | 160 | 200 |
| Dividends | <u>120</u> | <u>130</u> |
| Retained profit for the year | 40 | 70 |

Tips for success

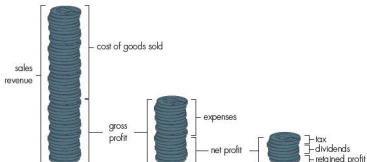
You must remember the important differences between gross profit, net profit and retained profit.

Activity 23.4: ABC's retained profit

- a) Using the same pattern as the typical income statement shown above, calculate the retained profits of ABC plc for the year ending 31/3/2013 from the following data (which is not in the correct order!).

| | (\$000) |
|--------------------|---------|
| Sales revenue | 280 |
| Tax paid | 40 |
| Operating expenses | 30 |
| Cost of sales | 100 |
| Interest paid | 15 |
| Dividends | 25 |

- b) Explain why retained profit is important to ABC's future success.



How retained profit is calculated

Revision summary: income statements

$$\text{gross profit} = \text{sales revenue} \\ \text{less cost of goods sold}$$

$$\text{net profit} = \text{gross profit} \\ \text{less expenses/overheads}$$

$$\text{retained profit} = \text{net profit} \\ \text{less tax and dividends}$$

INCOME STATEMENTS

shows profit/loss not cash flow

used by managers to compare business performance

important part of a company's published accounts

Using income statements in decision making

Managers can use the structure of income statements to help them in making decisions based on profit calculations. If a manager has to choose which of two new products to launch, one way of making this decision is to construct two forecasted income statements.

Case study example

Asif has to decide on which location would be best for a new shop. He has undertaken market research and forecasted the costs of these two locations. The information he has collected is shown below:

| Forecasted information for next year | Location A | Location B |
|--------------------------------------|------------|------------|
| Sales revenue | \$40 000 | \$60 000 |
| Cost of goods sold | \$16 000 | \$24 000 |
| Gross profit | \$24 000 | \$36 000 |
| Rent | \$10 000 | \$16 000 |
| Other expenses | \$5000 | \$8000 |
| Net profit | \$9000 | \$12 000 |

Case study example

Asif also considered other factors before making the final decision:

- Annual rent at Location B is fixed for five years, but only for two years at Location A.
- A new housing estate is planned to be built just six kilometres away from Location B.
- A potential competitor has just closed a shop near Location A.

Asif finally selected Location B for the new shop.

Activity 23.5

Read the case study above.

Do you think Asif took the right decision? Justify your answer.

Case study example – Joe's important decision

Joe is the new product manager at a chain of take-away food stores. He is planning to introduce a new type of 'fast food' – a pizza or a curry. He has two product options but the business can only afford to buy the equipment and advertising material needed for one of these options.

He has undertaken some market research and forecasted the main costs for the two product options. He has asked you to help him complete the following income statements:

| Forecasts for one year | Pizza option | Curry option |
|--------------------------|-----------------------|-----------------------|
| Sales revenue | 50 000 units @ \$3 | 40 000 units @ \$5 |
| Cost of goods sold | Unit cost of \$1 each | Unit cost of \$2 each |
| Gross profit | | |
| Annual equipment costs | \$13 000 | \$12 000 |
| Annual advertising costs | \$15 000 | \$20 000 |
| Other expenses | \$13 000 | \$15 000 |
| Net profit | | |

Tips for success

Business managers often have to use calculations as part of their job – don't be afraid of business calculations! This book explains all of the calculations you will need at IGCSE – practise all of the examples. Take a calculator into the examination with you!

Activity 23.6

Read the case study.

- Write out the two income statements.
- Fill in the totals for sales revenue and cost of goods sold.
- Calculate the gross profit and net profit of both product options.
- Identify and explain two other factors Joe should consider before making this decision.
- Joe finally decides on the curry option. After one year, he finds that profit from this product is much lower than expected. Evaluate two ways which Joe could use to try to increase profits from this product.

International business in focus: Sun Resorts revenue and net profit down

The second largest leisure group in Mauritius has announced that sales revenue and net profit (before tax) were down last year. Total sales revenue from its hotel and other leisure operations was 3.137 billion rupees in 2010, down from 3.533 billion rupees in 2009. Net profit fell from 407 million rupees to 226 million rupees. However, the company has recently reported that revenues in 2011 will be higher due to the opening of the huge Long Beach development. The company does not expect net profit to increase however, due to difficult times for the international tourist industry.

The financial crisis and falling living standards in Europe have reduce tourist numbers. International hotel chains are increasingly using promotional pricing of room prices to attract a bigger share of the market for tourists, which is not, currently, expanding.

Discussion points

- Why are profits important to a large hotel group such as Sun Resorts?
- Explain why the company expected revenue to increase in 2011 but not profits.
- Explain how Sun Resorts could try to increase its profits in future.

Exam-style questions – Paper 1

- 1 Ikram is a hairdresser. His sales revenue was 10 per cent higher this year than last year. He earned a total revenue of \$50 000 last year. He charged an average of \$5 for each customer last year and has not increased prices. He buys in materials such as shampoo and hairspray and has calculated that the cost is an average of \$2 for each customer. He estimates that his overhead expenses are \$10 000 this year.
- What is meant by 'sales revenue'? [2]
 - Calculate Ikram's sales revenue this year. Show your working. [2]
 - Identify **four** costs likely to be included in Ikram's annual overhead expenses. [4]
 - Calculate Ikram's net profit this year (using your result from b). Show your working. [6]
 - Ikram thinks that his net profit next year will be higher if he increases average prices to \$6 per customer. Do you agree? Justify your answer. [6]
- 2 Sue develops new computer games. She has developed two new games but she only has the capital to launch one of these. Game A is aimed at young children – around 6–10 years old. Game B is targeted at teenagers – around 13–18 years old. She has forecasted the following financial information:

| Forecasts for next year | Game A | Game B |
|-------------------------|------------------|-------------------|
| Sales revenue | 3000 units @ \$5 | 2000 units @ \$10 |
| Cost of sales | \$1.50 per unit | \$3 per unit |
| Expenses | \$4000 | \$9000 |

- What is meant by 'cost of sales'? [2]
- Identify **two** reasons why retained profit of a company is not the same as its net profit. [2]
- Identify and explain **two** ways in which Sue could try to increase sales revenue for any one of her existing games. [4]
- Identify and explain **two** other pieces of information that Sue would find useful before making a choice between game A and Game B. [6]
- Advise Sue which game she should launch. Use calculations to support your answer. [6]

Revision checklist

In this chapter you have learned:

- what is meant by accounting information and why it is important
- why profit is important to businesses and investors – and that it is not the same as cash
- to explain the differences between such concepts as gross profit, net profit and retained profit
- what the main features of income statements are and how these statements can be useful to managers when taking decisions.

NOW – test your understanding with the revision questions on the CD-ROM.

This chapter will explain:

- the main elements of a balance sheet
- the main classifications of assets and liabilities
- how to use examples to illustrate these classifications
- how to interpret simple balance sheets and make deductions from them.

Definitions to learn

The **balance sheet** shows the value of a business's assets and liabilities at a particular time. Sometimes referred to as 'statement of financial position'.

Assets are those items of value which are owned by the business. They may be fixed (non-current) or short-term current assets.

Liabilities are debts owed by the business.

Balance sheets

In the previous chapter, we learned how a manager can calculate whether the business is making a profit or a loss. This is clearly of great importance. However, by itself, the income statement does not tell us how much the business is worth. Business owners would be very interested to know how much their business is worth. This information, together with other details, is given on the **balance sheet**.

The balance sheet is very different from the income statement. The income statement records the income and expenses of a business, and the profit or loss it makes, over a period of time – usually one year. The balance sheet records the value or worth of a business at just one moment in time – at the end of the financial year.

A personal balance sheet example will help to introduce the basic concept of this account.

Case study example – a personal balance sheet

Sanchez plans to start his own business. A government business adviser asked him 'how much money can you put into the business?' and Sanchez had to admit, he did not really know!

The adviser asked him for an approximate value of everything he owned including any bank accounts – as well as any debts or loans that he had.

Together they made these two lists:

| All items owned by Sanchez | | All debts owed by Sanchez | |
|----------------------------|-----------------|---------------------------|-----------------|
| House | \$50 000 | Loan on house (mortgage) | \$18 000 |
| Car | \$4500 | Bank loan on car | \$3000 |
| Savings | \$3000 | Owes brother | \$1500 |
| Bank account | \$500 | | |
| Total | \$58 000 | Total | \$22 500 |

The adviser told Sanchez: 'The total value of what you own is \$35 500 more than the value of what you owe. This difference is called 'equity' and means that you could, theoretically, invest this much of your own capital into your new business. Unfortunately, it is not all in a cash form!'

Business balance sheets follow exactly the same principles. They list and give a value to all of the **assets** and **liabilities** of the business. It is important to understand these terms before the layout of the balance sheet is explained.

- Assets are those items of value which are owned by the business.

Land, buildings, equipment and vehicles are examples of non-current or fixed assets. They are likely to be kept by the business for more than one year. Most fixed assets, apart from land, depreciate over time so the value of these will fall on the balance sheet from one year to the next. Intangible assets are those that do not exist physically but still have a value – such as brand names, patents and copyrights.

Tips for success

You should take every chance to apply your answers to balance sheet questions to the business in the case. For example, if asked for 'two fixed assets of a shop' avoid suggesting 'factory' or flow line production machines! In this case, shop premises and delivery vehicles are much more likely to earn marks!

Cash, inventories (stocks) and accounts receivables (debtor customers who owe money to the business) are only held for short periods of time and are called current assets.

- Liabilities are items owed by the business. Again, there are two main forms of these.

Non-current liabilities (or long-term liabilities) are long-term borrowings which do not have to be repaid within one year.

Current liabilities are amounts owed by the business which must be repaid within one year, for example, bank overdraft and accounts payable (suppliers/creditors owed money by the business).

What is the importance of these terms? Refer again to the case study above giving details of Sanchez's own personal finances. The value of his assets is greater than the value of his debts or liabilities, so he owns wealth. In the case of a business, this wealth belongs to the owners; in the case of companies, it belongs to the shareholders. This is why the balance sheet is so important to the users of the accounts (the owners of the business). It shows how much wealth or equity the owners have invested in the business. They would obviously like to see this increase year by year.

Total assets – total liabilities = owners' equity (shareholders' funds in a limited company)

Case study example – company balance sheet

This is a typical balance sheet, for Ace Machines Ltd. The previous year's figures are also usually shown to allow for easy comparisons. The terms that have not yet been explained are looked at in more detail below.

Ace Machines Ltd. balance sheet as at 31/3/2013 (\$000)

| ASSETS | 2013 | 2012 |
|---|-------------|-------------|
| Non-current (fixed) assets | | |
| Land and buildings | 450 | 440 |
| Machinery | 700 | 600 |
| | 1150 | 1040 |
| Current assets | | |
| Inventories (stocks) | 80 | 50 |
| Accounts receivable (debtors) | 50 | 60 |
| Cash | 10 | 15 |
| | 140 | 125 |
| TOTAL ASSETS | 1290 | 1165 |
| LIABILITIES | | |
| Current liabilities | | |
| Accounts payable (creditors) | 65 | 40 |
| Bank overdraft | 65 | 60 |
| | 130 | 100 |
| Non current (long-term) liabilities | | |
| Long-term bank loan | 300 | 245 |
| Total liabilities | 430 | 345 |
| TOTAL ASSETS – TOTAL LIABILITIES | 860 | 820 |
| Shareholders' equity (shareholders' funds) | | |
| Share capital | 520 | 500 |
| Profit and Loss Account reserves | 340 | 320 |
| TOTAL SHAREHOLDERS' FUNDS/EQUITY | 860 | 820 |

Tips for success

There is more than one accounting term used for many balance sheet items (some of these are given in brackets). Cambridge use the standard international terminology as used in this chapter – but may give other terms as well to aid your understanding.

Definitions to learn

Non-current assets are items owned by the business for more than one year.

Current assets are owned by a business and used within one year.

Non-current liabilities are long-term debts owed by the business.

Current liabilities are short-term debts owed by the business.

Explanation of balance sheet terms

- **Non-current** and **current assets**, **current** and **non-current liabilities** – see pages 294–6.
- Total assets less total liabilities is always equal to total shareholders' funds or equity – otherwise the balance sheet would not balance!
- Shareholders' equity (or shareholders' funds) is the total sum of money invested into the business by the owners of the company – the shareholders. This money is invested in two ways:
 - Share capital is the money put into the business when the shareholders bought newly issued shares.
 - Reserves arise for a number of reasons. Profit and loss reserves are retained profits from current and previous years. This profit is owned by the shareholders but has not been paid out to them in the form of dividends. It is kept in the business as part of the shareholders' funds.

Activity 24.1: Understanding balance sheets

A Managing Director of a company is trying to write out the balance sheet for the business. The following items have been listed. You have been asked to help the Managing Director by putting them all under their correct heading. Copy out the table and tick the correct box for each item.

| | Current assets | Non-current assets | Current liabilities | Non-current liabilities | Share capital | Reserves |
|---------------------------|----------------|--------------------|---------------------|-------------------------|---------------|----------|
| Company vehicles | | | | | | |
| Cash in the till | | | | | | |
| Ten-year bank loan | | | | | | |
| Ordinary share capital | | | | | | |
| Money owed by customers | | | | | | |
| Unsold goods | | | | | | |
| Factory building | | | | | | |
| Retained profit | | | | | | |
| Amounts owed to suppliers | | | | | | |
| Tax owed to government | | | | | | |

Interpreting balance sheet data

- Shareholders can see if 'their' stake in the business has increased or fallen in value over the last 12 months by looking at the 'total equity' figures for two years.
- Shareholders can also analyse how expansion by the business has been paid for – by increasing non-current liabilities (such as long-term loans); from retained profits or by increasing share capital (sale of shares). If inventories or stocks have been sold off to provide capital for business expansion then this will be clear by this figure declining on the balance sheet.
- Working capital can be calculated from balance sheet data. This is a very important concept (see also Chapter 22). It is also known as net current assets. It is calculated by the formula:

$$\text{Working capital} = \text{current assets} - \text{current liabilities}$$

No business can survive without working capital. It is used to pay short-term debts. If these debts cannot be paid because the business does not have enough working capital, the creditors could force the business to stop trading.

- Capital employed can also be calculated by using data from the balance sheet. The following formula is used:

$$\text{Capital employed} = \text{shareholders' funds} + \text{non-current liabilities}$$

This is the total long-term and permanent capital of the business which has been used to pay for the assets of the business.

- Balance sheet data can also be used to calculate ratios which are used to assess business performance – see Chapter 25.

Case study example – using balance sheets

Refer to the balance sheet for Ace Machines Ltd on page 295.

Ace Machines Ltd manufactures washing machines and vacuum cleaners. Over the period shown by the balance sheets, the business invested heavily in new IT-based equipment for its production line. The retained profits of the business have been falling in recent years.

Some shareholders were studying the company's 2013 balance sheet and the following questions were raised.

Q: The business increased the value of fixed assets last year, but how was this financed?

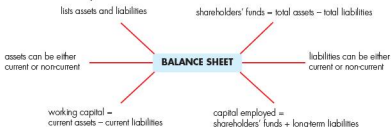
A: The business increased its bank loans, sold new shares and retained profit within the business.

Q: The value of inventories increased this year. Is this good?

A: Probably not if it resulted from not being able to sell a higher level of output to customers.

These inventories have to be financed somehow – and there is an opportunity cost to this! The money tied up in inventories could have been used in other ways within the business.

Revision summary: balance sheet



Tips for success

A balance sheet is useful to many stakeholder groups – to help analyse the performance and financial strength of a business. They can also be compared with balance sheets from previous years or other businesses. See Chapter 25 for more detail of how business accounts can be analysed.

Activity 24.2: Using balance sheet data

Refer to Ace Machines Ltd's balance sheets on page 295.

- Calculate the increase in working capital between the two years shown.
- Comment on your result.
- Which source of finance provided most capital during 2013: loans, share issues or retained profit? Explain your answer.
- Do you think that this business should reduce the value of its inventories? Explain your answer.
- Do you think the shareholders of Ace Machines Ltd should be pleased with the balance sheet data? Explain your answer.

Activity 24.3: Comparing balance sheet data

KL Co. Ltd and HK Co. Ltd are two businesses that manufacture gifts bought by tourists – such as pottery and wooden carvings. The following table contains a summary of the two companies' balance sheets for the year ending 31/10/13.

| | KL Co. Ltd (\$000) | HK Co. Ltd (\$000) |
|----------------------------------|--------------------|--------------------|
| Non-current assets | 50 | 120 |
| Current assets: | | |
| Inventories | 12 | 50 |
| Accounts receivable | 8 | 16 |
| Cash | 1 | 4 |
| Total assets | x | 190 |
| Current liabilities | 18 | 70 |
| Non-current liabilities | 20 | 30 |
| Total liabilities | 38 | 100 |
| Total assets – total liabilities | y | 90 |
| Shareholders' equity: | | |
| Share capital | 20 | 75 |
| Retained profit | 13 | z |
| Total shareholders' equity | 33 | 90 |

- Calculate the values for x, y and z.
- Identify two types of non-current assets that these businesses are likely to own.
- Identify three items that are likely to be held as inventories by these businesses.
- Which company seems to be in a stronger financial position? Use the data above to support your answer.

International business in focus: Hayley's balance sheet

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Hayley's is one of Sri Lanka's largest public limited companies. It is a very diversified business with divisions operating in agriculture, transport, consumer products and aviation. The company has recently completed a contract to install lighting at Hambabotota Cricket Ground, it has refurbished the Ceylon Continental Hotel and invested in a project to generate green electricity from coconut shell charcoal. A summary of the Hayley Group balance sheet is shown below.

| All figures in rupees, '000 000 | As at 31/3/11 | As at 31/3/10 |
|------------------------------------|---------------|---------------|
| Non-current assets | 29 595 | 23 453 |
| Current assets | 24 204 | 21 415 |
| Total assets | 53 799 | 44 868 |
| Non-current liabilities | 9268 | 5176 |
| Current liabilities | 20 640 | 17 359 |
| Total liabilities | 29 908 | 22 535 |
| Total equity (shareholders' funds) | 23 891 | 22 333 |

Discussion points

- Suggest two non-current (fixed) assets that the transport division of Hayley's is likely to own.
- Suggest why the company increased non-current liabilities (long-term loans) in the period shown above.
- Do you think that the shareholders in Hayley would be pleased with the 2011 balance sheet? Explain your answer.

Exam-style questions – Paper 1

- 1 An extract from Acme Builders Ltd latest balance sheet is shown below. During the period shown the government increased interest rates – the cost of borrowing money. A competitor business is for sale. The owners have asked the directors of Acme Builders if they wish to buy the business for \$4 million.

Extract from Acme Builders Ltd balance sheet

| | As at 31/9/2013 (\$m) | As at 31/3/2012 (\$m) |
|-----------------------------------|-----------------------|-----------------------|
| Non-current assets | 67 | 58 |
| Current assets | 23 | 15 |
| Non-current liabilities | 12 | 6 |
| Total equity (shareholders funds) | 57 | 50 |

- a) What is meant by 'non-current assets'? [2]
 b) Identify **two** current assets likely to be held by Acme Builders Ltd. [2]
 c) Identify and explain **two** possible reasons why the company increased its value of total equity (shareholders funds) during the period shown. [4]
 d) Identify and explain **two** ways in which the increase in non-current liabilities (long-term loans) might have been used by the company. [6]
 e) Consider how useful the information above would be to the directors of Acme Builders Ltd when they decide whether or not to take over the competing business for \$4 million. Justify your answer. [6]
- 2 An extract from Penang Garages plc latest balance sheet is shown below. The garage company sells cars and repairs old vehicles. It has many competitors.

Extract from Penang Garages plc balance sheet

| All figures in \$m | As at 31/12/13 | As at 31/12/12 |
|-----------------------------------|----------------|----------------|
| Non-current assets | 96 | 90 |
| Current assets | 23 | 25 |
| Non-current liabilities | 35 | 40 |
| Current liabilities | 28 | 25 |
| Total equity (shareholders funds) | 56 | 50 |

- a) What is meant by 'total equity' (or shareholders' funds)? [2]
 b) Identify **two** current liabilities Penang Garages is likely to have. [2]
 c) Identify and explain **two** possible reasons why the value of current assets has fallen during the period shown. [4]
 d) Identify and explain the usefulness of **two** pieces of information, other than the data above, that a potential shareholder might need to analyse before investing in Penang Garages plc. [6]
 e) Do you think that the shareholders of Penang Garages plc would be pleased with the information shown above? Justify your answer. [6]

Revision checklist

In this chapter you have learned to:

- understand what is meant by accounting information and why it is particularly important to business managers
- list all of the users of a business's accounts and understand their need for accounting information
- explain the main business accounting records and final accounts
- explain the differences between such concepts as assets and liabilities; current and fixed assets.

NOW – test your understanding with the revision questions on the CD-ROM.

Analysis of accounts

This chapter will explain:

- how to interpret financial statements by calculating and analysing ratios
- profitability ratios: gross profit margin; net profit margin; return on capital employed
- the concept of liquidity and liquidity ratios: current ratio; acid test
- how accounts are used; by which groups and their different needs
- how users of accounts can use ratio results to help make decisions.

Analysis of published accounts

The company accounts we have studied contain a great deal of information. These published accounts of limited companies are made available to all those interested in the performance of the business. There are many stakeholders who will analyse company accounts. We must now look at how these accounts can be used and analysed to give the information these groups need.

Q: What is meant by 'analysis of accounts'?

A: It means using the data contained in the accounts to make some useful observations about the performance and financial strength of the business.

Without 'analysis of accounts' it is often impossible to tell whether a business is:

- performing better this year than last year
- performing better than other businesses.

Tips for success

You should be able to explain why just one figure taken from the accounts of a business tells us very little about the performance or final strength of that business.

Case study example

Consider these results for two food retailing companies:

| | Freshfoods plc | Foodstore plc |
|-------------------|----------------|---------------|
| Net profit (2013) | \$300 000 | \$30 000 |

What conclusions can be drawn from these figures?

- Is Freshfoods plc much more successful than Foodstore plc? You may think so just from these figures.
- Is the management of Freshfoods plc ten times more efficient than the management of Foodstore plc?
- Is Freshfoods plc making much better use of its assets than its competitor is?
- Is the profit margin made on each item sold much higher in one company than the other?

Definite answers to these questions cannot be given unless other information is considered.

Take, for example, the total value of **capital employed** by both of these businesses:

| | Freshfoods plc | Foodstore plc |
|-------------------------|----------------|---------------|
| Capital employed (2013) | \$900 000 | \$60 000 |

Which company seems to have made more efficient use of the capital invested? We need to compare net profit made with capital employed in each company.

Foodstore plc has made \$30 000 profit from an investment of \$60 000 and Freshfoods plc has made \$300 000 profit from an investment of \$900 000. By comparing two figures from the accounts, Foodstore plc appears to have achieved a better performance even though its overall level of profits is lower.



It is impossible to tell which of these businesses is more profitable without analysing their accounts

Definitions to learn

Liquidity is the ability of a business to pay back its short-term debts.

Capital employed is shareholders' equity plus non-current liabilities and is the total long-term and permanent capital invested in a business.

This example shows how important it is to use more than one figure from the accounts when trying to assess how a business is performing. Comparing two figures from the accounts in this way is called ratio analysis. This is a very important way of analysing the published accounts.

Ratio analysis of accounts

There are many ratios which can be calculated from a set of accounts. This chapter concentrates on five of the most commonly used. These ratios are used to measure and compare profitability (or performance) and **liquidity** of a business.

Profitability ratios

Three commonly used profitability ratios are:

1 Return on capital employed (ROCE).

This is calculated by the formula:

$$\frac{\text{Net profit}}{\text{Capital employed}} \times 100$$

Case study example

ABC Computing Ltd made a net profit of \$280 million in 2013 and its **capital employed** was \$1065 million. Its return on capital employed in 2013 was:

$$\begin{aligned} & \frac{\text{Net profit}}{\text{Capital employed}} \times 100 \\ &= \frac{280}{1065} \times 100 \\ &= 26.3\% \end{aligned}$$

This means that in 2013, the company made a return on the capital employed in the business of 26.3 per cent. The higher this result, the more successful the managers are in earning profit from capital used in the business. If this percentage increases next year, it means that the managers are running the business more efficiently – making higher profits from each dollar invested in the business.

This result should now be compared with other years and other companies to see if the managers are running the business more efficiently or not.

2 Gross profit margin.

This is calculated by the formula:

$$\text{Gross profit margin (\%)} = \frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$$

Case study example

ABC Computing Ltd made a gross profit in 2013 of \$400 million. Total sales revenue was \$1300 million.

$$\begin{aligned}\text{Gross profit margin} &= \frac{400}{1300} \times 100 \\ &= 30.8\%\end{aligned}$$

This means that on every \$1 worth of goods sold, the company made on average 30.8 cents gross profit. Do not forget that this is before other expenses have been deducted and is not the final profit of the company. Again, this result needs to be compared with other years and other companies.

If this percentage increases next year it would suggest that:

- prices have been increased by more than the cost of goods have risen or that
- costs of goods bought in have been reduced. Possibly a new supplier is being used or managers have negotiated lower cost prices.

3 Net profit margin (also known as profit margin).

This is calculated by the formula:

$$\text{Net profit margin (\%)} = \frac{\text{Net profit}}{\text{Sales revenue}} \times 100$$

Case study example

ABC Computing Ltd made a net profit of \$240m in 2013.

$$\begin{aligned}\text{Net profit margin} &= \frac{240}{1300} \times 100 \\ &= 21.5\%\end{aligned}$$

The company made 21.5 cents net profit on each \$1's worth of sales. This is lower than the gross profit margin because all other expenses including interest have been deducted from gross profit to arrive at net profit before tax. The higher this result, the more successful the managers are in making net profit from sales. What could this result be compared with? Again, it should be compared with with other years and other companies.

Profitability ratios – what do they tell us?

One profitability ratio result is not very useful. When a ratio result is compared with others, then some effective analysis can be done. Here are some examples taken from the same business:

| Ratio results | Observation | Analysis |
|--|---|---|
| Gross profit margin: 2012 – 20% 2013 – 24% | This means that the gross profit on each \$1 of sales has increased. | The business is more successful at converting sales into profit. Either the price of goods has increased (by more than costs) or the cost of goods sold has fallen (but price has not been reduced at all or not by as much). |
| Net profit margin: 2012 – 14% 2013 – 12% | This means that the net profit on each \$1 of sales has fallen – even though gross profit margin has increased. | The business is less successful at converting sales into net profit. The overhead/fixed costs of the business must have increased significantly during the year – reducing the company's net profit compared to sales revenue. |
| Return on capital employed: 2012 – 10% 2013 – 6% | The profit made for each \$1 invested in the business has fallen. | This must be because either net profit has fallen or capital employed has increased. If capital employed has increased, this could mean that the managers of the business have invested more, hoping to make higher profit in future. |

Activity 25.1: ABC Computing Ltd – profitability

| ABC Computing Ltd – 2012 accounts summary | \$m |
|---|------|
| Sales revenue | 1200 |
| Gross profit | 450 |
| Net profit | 220 |
| Capital employed | 965 |

- a) Using the 2012 accounting information above for Ace Computing Ltd calculate:
- return on capital employed
 - gross profit margin
 - net profit margin.
- b) Refer to your results and the case studies on pages 303–4. Do you feel that the company performed better in 2012 or 2013? Give reasons for your answer.

Definitions to learn

Illiquid means that assets are not easily convertible into cash.

The concept of liquidity

This measures a very important feature of a business. Liquidity is the ability of a business to pay back its short-term debts. If a business cannot pay its suppliers for materials that are important to production or if the business cannot repay an overdraft when required to, it is said to be **illiquid**. The businesses it owes money to may force it to stop trading and sell its assets so that the debts are repaid.

Liquidity ratios

Two commonly used liquidity ratios are:

1 Current ratio

This is calculated by the formula:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Case study example

ABC Computing Ltd had current assets valued at \$125 million in 2013 and current liabilities of \$100 million.

$$\text{Current ratio} = \frac{125}{100} = 1.25$$

This result means that the business could only just pay off all of its short-term debts from current assets. This is an acceptable result but a really 'safe' current ratio would be between 1.5 and 2. If the current ratio is less than 1, it would mean that the business could have real cash flow problems. It could not pay off its short-term debts from current assets.

More effective analysis of liquidity is possible if results for previous years and other similar businesses are available. If the current ratio is very high, say over 2.0, it could mean that too much working capital is tied up in unprofitable current assets.

The current ratio is useful but it assumes that all current assets could be turned into cash quickly. This is not always the case. For example, it might be very difficult to sell all inventories in a short period of time. For this reason a second liquidity ratio is used.

2 Acid test or liquid ratio

This is calculated by the formula:

$$\text{Acid test ratio} = \frac{\text{Current assets} - \text{inventories}}{\text{Current liabilities}}$$

Case study example

ABC Computing Ltd had \$50 million of inventories at the end of 2013. Its acid test ratio can now be calculated:

$$\text{Acid test ratio} = \frac{125 - 50}{100} = 0.75$$

A result of 1 would mean that the company could just pay off its short-term debts from its most liquid assets. This is usually considered to be an acceptable acid test result. This result of 0.75 means that it cannot do this. This might be worrying for the management and steps may have to be taken to improve the liquidity of the business – for example, reduce the level of inventories by selling some for cash.

Liquidity ratios – what can they tell us?

One liquidity ratio result is not very useful. When a ratio result is compared with others, then some effective analysis can be done. Here are some examples taken from the same business:

| Ratio results | Observation | Analysis |
|---|---|---|
| Current ratio 1.0 – 2013 Current ratio 1.5 – 2012 | The current ratio has fallen during 2013. | This could be because the business has bought and used many more supplies, but not yet paid for them. It could also be because the business has used cash to pay for fixed assets. The business has low liquidity and needs to increase current assets or reduce current liabilities. |
| Current ratio 1.75 – 2013 Acid test ratio 0.5 – 2013 | The current ratio is acceptable and much higher than the acid test ratio. | The acid test ratio might be too low – the business might be at risk of not being able to pay its short-term debts from its liquid assets – cash and accounts receivable (debtors). The great difference between the two results is because of a relatively high level of inventories. |

Tips for success

You should be able to explain why just one ratio result is of limited use in analysing the performance or liquidity of a business.

Activity 25.2: ABC Computing Ltd – liquidity

| ABC Computing Ltd – 2012 accounts summary | \$m |
|---|-----|
| Current assets | 135 |
| Inventories | 40 |
| Current liabilities | 95 |

- a) Using the information above for ABC Computing Ltd, calculate the following ratios for 2012:
- current ratio
 - acid test ratio.
- b) Do you think the management of ABC Computing should be satisfied with the liquidity of the company? Justify your answer using your results from a) and the 2013 results on page 306.

Uses and users of accounts

Who uses the accounts of a business? Which groups would analyse a company's accounts, such as by calculating ratios? As it is only the accounts of public limited companies that have to be published, we shall concentrate on the uses and users of these. The following groups have an interest in a public limited company's accounts and the ratios based on them.

| User of accounts | What they use the accounts for |
|--|--|
| Managers: they will be able to have much more detailed and frequent accounting information than any of the other groups. | <p>They will use the accounts to help them keep control over the performance of each product or division of the business. Managers will be able to identify which parts of the business are performing well or poorly.</p> <p>Accounting data will help in decision making, for example whether to expand the business, change price levels or close down a product or division that is not doing well.</p> <p>Managers will calculate accounting ratios too. Ratios are very useful and a quick way for managers to compare their company's profit performance and liquidity. Ratio results may be compared with:</p> <ul style="list-style-type: none"> ● other years ● other businesses. <p>It is important to compare accounting ratios in these ways. One ratio result on its own means very little. Consider this example: Hurtwood Trading Co. Ltd return on capital employed 2013 – 12%. Is this a good or a bad result? This question can only be answered by managers looking at past results and other companies. For example, here is some additional information: Hurtwood Trading Co. Ltd return on capital employed 2012 – 5.8%. Westbay Trading Co. Ltd return on capital employed 20013 – 20%. Now the managers of Hurtwood Trading can make realistic comparisons. Their company is performing more effectively than in the previous year but it still needs to improve further to equal the performance and profitability of one of the company's closest rivals.</p> |
| Shareholders: limited companies are owned by shareholders and they have a legal right to receive the published accounts each year. | <p>Shareholders – and potential investors – want to know, from the income statement, how big a profit or loss the company made. The profitability ratio results will be compared with last year's. The higher the profitability ratio results are, the more likely shareholders will want to invest by buying more shares in the company. They will want to know, from the balance sheet, if the business is worth more at the end of the year than it was at the beginning. They will also assess the liquidity of the business – they do not want to invest in a company with serious cash or liquidity problems.</p> |
| Creditors: these are other businesses which have supplied goods to the company without yet receiving payment. | <p>The balance sheet will indicate to creditors the total value of debts that the company has to pay back and the cash position of the company.</p> <p>Liquidity ratios, especially when compared with the previous year, will indicate the ability of the company to pay back all of its creditors on time.</p> <p>If these results suggest the company has a liquidity problem, suppliers may refuse to supply goods on credit.</p> |
| Banks: these may have lent money to the company on a short- or long-term basis. | <p>They will use the accounts in a similar way to creditors. If the business seems to be at risk of becoming illiquid, it is unlikely that a bank will be willing to lend more.</p> |
| Government | <p>The government and the tax office will want to check on the profit tax paid by the company. If the company is making a loss, this might be bad news for the government's control of the whole economy, especially if it means that workers' jobs may be lost.</p> |

(continued)

| User of accounts | What they use the accounts for |
|--|---|
| Workers and trade unions | Workers and trade unions will want to assess whether the future of the company is secure or not. In addition, if managers are saying that 'they cannot afford to give workers a pay rise' it would be useful for workers and unions to assess whether the profits of the company are increasing or not. |
| Other businesses – especially those in the same industry | The managers of other companies may be considering a bid to take over the company or they may just wish to compare the performance of the business with that of their own. Other businesses will compare their performance and profitability with others in the same industry. |

All of these users of accounts need to remember that ratio analysis does not provide 'all the answers' to the many questions they have about the performance and financial strength of a business.

Limitations of using accounts and ratio analysis

- Managers will have access to all accounts data – but the external users will only be able to use the published accounts which contain only data required by law.
- Ratios are based on past accounting data and may not indicate how a business will perform in the future.
- Accounting data over time will be affected by inflation (rising prices), and comparisons between years may be misleading.
- Different companies may use slightly different accounting methods, for example in valuing their fixed assets. These different methods could lead to different ratio results, therefore making comparisons difficult.

Revision summary: business accounts



Case study example – using ratios to help make decisions

Gloria Hotels is a public limited company that owns three hotels in the capital city. The tourist industry in the country is expanding but there are many competing hotel companies in the capital city. The company accountant has calculated the following ratio results from the latest published accounts:

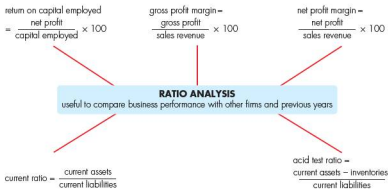
| Gloria Hotels plc | 2013 | 2012 |
|----------------------------|------|------|
| Return on capital employed | 13% | 17% |
| Gross profit margin | 35% | 30% |
| Net profit margin | 12% | 16% |
| Current ratio | 1.2 | 1.4 |
| Acid test ratio | 0.6 | 1.0 |

Activity 25.3

Read the case study above.

- Do you think the management of Gloria Hotels should be satisfied with the profitability of the company? Justify your answer.
- Explain why comparing these ratio results with other hotel companies would be useful for Gloria Hotels management.
- Do you think that Gloria Hotels' bank and creditors should be satisfied with the liquidity of the company? Justify your answer.
- Suggest and explain two ways in which the management of Gloria Hotels could increase the profitability of the company. Which way would you recommend and why?
- Suggest and explain two ways in which the management of Gloria Hotels could increase the liquidity of the company. Which way would you recommend and why?

Revision summary: ratio analysis



Tips for success

Be prepared to explain why different stakeholder groups will find useful information from a company's published accounts – and why ratios will help in the analysis of these accounts.

International business in focus: BP plc



BP is one of the world's largest oil companies. But is it also one of the most profitable? Ratio analysis of the company's accounts leads to some interesting results – which can be compared with other businesses in the same market sector.

In 2011 BP's return on capital employed was 21.33% – substantially higher than the average for the sector of 11.21%. The net profit margin was 6.84% which was a higher result than in 2010 and also slightly better than one of its main rivals, Royal Dutch Shell which recorded a net profit margin of 6.58%.

Is BP's profitability at the cost of low liquidity? It does not appear to be the case. In 2011 the company recorded an acid test ratio of 0.85 and a current ratio of 1.16 – both higher results than those recorded four years previously.

Will BP be able to maintain profitability and liquidity at times of world economic problems and rising oil prices?

Discussion points

- Which groups of BP's stakeholders would be interested in these ratio results and why?
- Explain why it is important to compare ratio results with those of other years and other similar companies

Exam-style questions – Paper 1

- 1 The table below is an extract from the accounts of Triton Canning Ltd, a food canning and processing business. The company sells its products to the three main supermarket groups in the country.

| | 2013 (\$m) | 2012 (\$m) |
|------------------|------------|------------|
| Gross profit | 300 | 285 |
| Net profit | 120 | 140 |
| Sales revenue | 3000 | 2500 |
| Capital employed | 1000 | 900 |

- What is meant by 'capital employed'? [2]
 - Identify **two** possible reasons why sales revenue has increased. [2]
 - Identify and explain **two** possible reasons why gross profit has increased. [4]
 - Identify and explain **two** ways in which Triton Canning's management could increase net profit. [6]
 - Do you think the management of Triton Canning should be satisfied with the profitability of the company? Calculate the return on capital employed ratio for both years to support your answer. [6]
- 2 The table below is an extract from the accounts of Hi Fashion Ltd. This is a private limited company that sells quality fashion clothes. It purchases from some leading manufacturers. It recently started offering its customers two months' credit. However, sales have been falling due to increased competition. The bank manager is worried about the liquidity of Hi Fashion Ltd.

| | 2013 (\$000) | 2012 (\$000) |
|---------------------|--------------|--------------|
| Current assets | 88 | 80 |
| Inventories | 48 | 35 |
| Current liabilities | 60 | 40 |

- What is meant by 'liquidity'? [2]
- Identify **two** likely current assets of Hi Fashion, apart from inventories. [2]
- Identify and explain **two** possible reasons why the current liabilities of the business are increasing. [4]
- Identify and explain why any **two** stakeholder groups, apart from the bank, would be interested in Hi Fashion Ltd's accounts. [6]
- Do you think the bank is right to be worried about Hi Fashion Ltd's liquidity? Use ratios to support your answer. [6]

Revision checklist

In this chapter you have learned:

- why ratios are important in analysing accounts
- how to calculate gross profit margin and understand the result
- how to calculate net profit margin and understand the result
- how to calculate return on capital employed and understand the result
- how to calculate the liquidity ratios – current ratio and acid test ratio – and understand the results
- which groups use analysis of business accounts and ratio analysis and how these can help make decisions.

NOW – test your understanding with the revision questions on the CD-ROM.

Financial information and financial decisions: end of section case study (Paper 2 style)

Fruity Smoothies



Fruity Smoothies is a public limited company which produces a range of fruit smoothies. The business operates in many different countries across the world. Fruity Smoothies is a successful company but the Directors want to increase its market share of the fruit smoothies global market.

The following two ways of increasing market share have been identified:

- Option 1: Increase sales of its most popular brand of smoothies by selling it in five new countries. The investment required to get the smoothies launched into new markets is estimated to be \$80 million. This includes market research, marketing campaigns and building factories to produce the fruit smoothies in the other countries.
- Option 2: Take over a competitor which sells a different range of brands of smoothies. The cost of the takeover to buy all the shares in the company is estimated to be \$160 million.

Appendix 1

Summary of financial information for Fruity Smoothies 2013

| | |
|--|---------------------|
| Existing business | \$m per year |
| Capital employed | 800 |
| Sales revenue | 1600 |
| Gross profit | 1200 |
| Net profit | 200 |
| Option 1 | \$m per year |
| Predicted sales revenue from five more countries | 400 |
| Fixed costs | 160 |
| Variable costs for additional sales | 220 |
| Option 2 | \$m per year |
| Predicted sales revenue from competitors' sales | 400 |
| Fixed costs | 120 |
| Variable costs of competitor | 220 |

Appendix 2*Information on Country X and Country Y*

| | Country X | Country Y |
|-------------------------|--|--------------------|
| Average income per head | \$6000 | \$40 000 |
| Population | 20m | 20m |
| Competitors' sales | \$20m per year | \$200 000 per year |
| Climate | Seasons (hot in summer and cold in winter) | Hot all year round |
| Average wage rate | \$2 per hour | \$20 per hour |
| Unemployment rate | 24% | 4% |
| Rents | low | high |

- 1 a) Identify and explain, using examples, the difference between fixed costs and variable costs for Fruity Smoothies. [8]
 b) Using the information in Appendix 1, consider the two options for increasing the market share of Fruity Smoothies. Recommend which one of the two options the Directors should choose. Justify your choice using appropriate calculations of profitability ratios. [12]
- 2 a) Both Option 1 and Option 2 requires capital for the expansion. Identify and explain four suitable sources of finance the Directors of Fruity Smoothies could use. [8]
 b) Fruity Smoothies might take over a competitor which sells fruit smoothies. Consider how important the competitors' balance sheet and income statement would be in helping the Directors of Fruity Smoothies decide whether to take over the competitor. Justify your answer. [12]
- Optional questions**
- 3 a) The Directors of Fruity Smoothies want to increase its market share. Identify and explain two other aims the Directors might have for the business. [8]
 b) If Fruity Smoothies try to sell their smoothies in several new countries they will have a number of problems to overcome. Consider three problems for the business when entering a new market in a different country. Do you think each of these problems can be easily overcome? Justify your answer. [12]
- 4 a) Fruity Smoothies sells a wide range of branded smoothies. Identify and explain two ways that Fruity Smoothies could create a brand image for a new fruit drink aimed at teenagers. [8]
 b) Fruity Smoothies is considering building a new factory to produce and sell fruit smoothies in one of the two countries shown in Appendix 2. Consider the advantages and disadvantages of the two countries. Recommend which country they should choose to build the new factory. Justify your choice. [12]

Section

6

External influences on business activity

Chapters

- 26 Government economic objectives and policies
- 27 Environmental and ethical issues
- 28 Business and the international economy



Government economic objectives and policies

This chapter will explain:

- government economic objectives
- the main stages of the business cycle
- the tax and spending changes that governments can make
- the interest rate changes that governments can make
- the impact these changes have on businesses and how they can react to these changes.

Definitions to learn

Inflation is the increase in the average price level of goods and services over time.

Unemployment exists when people who are willing and able to work cannot find a job.

Economic growth is when a country's Gross Domestic Product increases – more goods and services are produced than in the previous year. The **balance of payments** records the difference between a country's exports and imports.

Real income is the value of income, and it falls when prices rise faster than money income.

Government economic objectives

Most governments have the following economic objectives:

- low **inflation**
- low **unemployment**
- **economic growth**
- **balance of payments** between imports and exports.

Low inflation

Inflation occurs when prices rise. Low inflation is an important objective. When prices rise rapidly it can be serious for the whole country. These are the problems a country will have if there is rapid inflation:

- Workers' wages will not buy as many goods as before. This means that people's **real incomes** will fall. Real income is the value, in terms of what can be bought, of an income – if a worker receives a 6 per cent wage increase but prices rise by 10 per cent in the same year, then the worker's real income has fallen by 4 per cent. Workers may demand higher wages so that their real incomes increase.
- Prices of the goods produced in the country will be higher than those in other countries. People may buy foreign goods instead. Jobs in that country will be lost.
- Businesses will be unlikely to want to expand and create more jobs in the near future. The living standards are likely to fall.

Therefore low inflation can encourage businesses to expand and it makes it easier for a country to sell its goods and services abroad.



High rates of inflation reduce real incomes

Low unemployment

When people want to work but cannot find a job, they are unemployed. These are the problems unemployment causes:

- Unemployed people do not produce any goods or services. The total level of output in the country will be lower than it could be.
- The government pays unemployment benefit to those without jobs. A high level of unemployment will cost the government a great deal of money. This cannot be spent on other things such as schools and hospitals.

Therefore, low unemployment will help to increase the output of a country and improve workers' living standards.



High unemployment reduces output and can reduce living standards

Definitions to learn

Gross Domestic Product (GDP) is the total value of output of goods and services in a country in one year.

Economic growth

An economy is said to grow when the total level of output of goods and services in the country increases. The value of goods and services produced in a country in one year is called **gross domestic product (GDP)**. When a country is experiencing economic growth, the standard of living of the population is likely to increase.

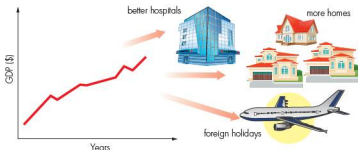
When a country's GDP is falling there is no economic growth. The problems this causes are:

- As output is falling, fewer workers are needed and unemployment will occur.
- The average standard of living of the population – the number of goods and services they can afford to buy in one year – will decline. In effect, most people will become poorer.
- Business owners will not expand their firms as people will have less money to spend on the products they make.

Economic growth, however, makes a country richer and allows living standards to rise.

Tips for success

You will not be asked questions about the economy of your own country. However, it is a good idea to find out about growth, inflation and unemployment rates in your country.

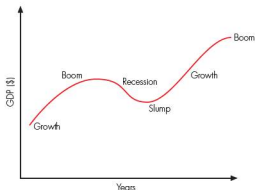


Economic growth will make a country richer and will allow living standards to rise

The business cycle

Economic growth is not achieved steadily every year – there are often years when the economy does not grow at all or when the value of GDP actually falls. This pattern is shown below on the trade cycle diagram.

The business cycle (sometimes known as the trade cycle) has four main stages, as shown on the diagram.



A business cycle diagram

- **Growth** – this is when GDP is rising, unemployment is generally falling and the country is enjoying higher living standards. Most businesses will do well at this time.
- **Boom** – this is caused by too much spending. Prices start to rise quickly and there will be shortages of skilled workers. Business costs will be rising and firms will become uncertain about the future.
- **Recession** – often caused by too little spending. This is a period when GDP actually falls. Most businesses will experience falling demand and profits. Workers may lose their jobs.
- **Slump** – a serious and long-drawn-out recession. Unemployment will reach very high levels and prices may fall. Many businesses will fail to survive this period.

Clearly, governments will try to avoid the economy moving towards a recession or a slump, but will also want to reduce the chances of a boom. A boom with rapid inflation and higher business costs can often lead to the conditions that result in a **recession**.

Balance of payments

Exports are goods and services sold by one country to people and businesses in another country. These bring money (foreign currency) into a country. **Imports** are goods bought in from other countries. These must be purchased with foreign currency so these lead to money flowing out of a country. Governments will aim to achieve equality or balance between these over a period of time. The difference between a country's exports and imports is called the balance of payments.

If the value of a country's imports is greater than the value of its exports then it has a balance of payments deficit.

These are the problems that could result:

- The country could 'run out' of foreign currencies and it may have to borrow from abroad.

Definitions to learn

Recession – a period of falling Gross Domestic Product.

Exports are goods and services sold from one country to other countries.
Imports are goods and services bought in by one country from other countries.

Definitions to learn

The **exchange rate** is the price of one currency in terms of another, for example £1: \$1.5. **Exchange rate depreciation** is the fall in the value of a currency compared with other currencies.

- The price of the country's currency against other currencies – the **exchange rate** – will be likely to fall. This is called **exchange rate depreciation**. The country's currency will now buy less abroad than it did before depreciation. Exchange rates are explained further in Chapter 28.

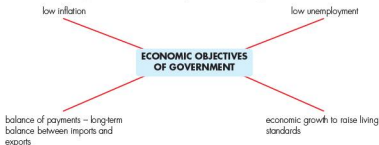


A balance of payments deficit can lead to major problems for a country

Activity 26.1

- The GDP of Country A was \$500 million in 2010. The population was 1 million. The average income per person was therefore \$500. By 2013, as a result of economic growth, GDP was \$1500 million. The population had also risen to 2 million. What was the average income per person in 2013?
- Joe earned \$20 000 in 2012. He had a pay rise of 10 per cent in 2013. Inflation was 15 per cent in 2013.
 - How much did Joe earn in 2013?
 - Did his real income rise or fall in 2013? Explain your answer.
- For Country A, identify which of the following are imports or exports:
 - washing machines purchased from Country B
 - cars made in Country A's factories and sold to a garage in Country B
 - machines sold to Country A from Country B
 - tourists from Country B who spend two weeks on holiday in a hotel in Country A.

Revision summary: economic objectives of government



Government economic policies

Governments have a great deal of economic power. They raise taxes and spend this money on a wide range of services and state benefits. It is not unusual for governments to have control over 40–50 per cent of a country's GDP through the

Definitions to learn

Fiscal policy is any change by the government in tax rates or public-sector spending.

taxes they raise. Governments use this power to try to achieve the objectives we have just looked at. The decisions made by government can have a great effect on all businesses in a country. Business managers need to know how their firm could be affected by government economic decisions. The main ways in which governments can influence the economy – sometimes called economic policies – are:

- **fiscal policy** – taxes and government spending
- **monetary policy** – interest rates
- **supply side policies**.

Fiscal policy: taxes and government spending

All governments spend money. They spend it on schools, hospitals, roads, defence, and so on. This expenditure is very important to some businesses. For example:

- construction firms will benefit from a new road building scheme
- defence industries will gain if the government re-equips the army
- bus manufacturers will benefit from government spending on public transport.

Q: Where do governments raise this money from?

A: Largely from taxes on individuals and businesses.

Q: What are the main types of taxes?

A: **Direct taxes** on the income of businesses and individuals and **indirect taxes** on spending.

Q: How do these taxes affect business activity?

A: In a number of different ways.

We will look at these effects by studying the impact of four common taxes:

- income tax
- profits tax or corporation tax
- indirect taxes, for example Value Added Tax (VAT)
- import tariffs.

Definitions to learn

Direct taxes are paid directly from incomes – for example, income tax or profits tax.

Indirect taxes are added to the prices of goods and taxpayers pay the tax as they purchase the goods – for example, VAT.

Definitions to learn

Disposable income is the level of income a taxpayer has after paying income tax.

Income tax

This is a tax on people's incomes. Usually, the higher a person's income the greater will be the amount of tax they have to pay to the government. Income tax is set at a certain percentage of income, for example 25 per cent of income. In many countries, income tax is progressive. This means that the rich pay tax at a higher rate than the poor.

How would businesses be affected by an increase in the rate of income tax? Individual taxpayers would have a lower **disposable income**. They would have less money to spend and save. Businesses would be likely to see a fall in sales. Managers may decide to produce fewer goods as sales are lower. Some workers could lose their jobs.



Which businesses are likely to be most affected by this increase in income tax rates? Businesses which produce luxury goods which consumers do not have to buy are likely to be the most affected. Businesses producing essential goods and services will be less affected. Consumers will still have to buy these products.

Case study example

The government of Country A has set the following rates of income tax:

| Income level | Tax rate paid to government |
|---------------------------|-----------------------------|
| \$1–\$5000 per year | 20% |
| More than \$5000 per year | 30% |

How much tax would John, earning \$10 000 per year, pay to the government? The answer is \$2500. This is worked out as follows:

20 per cent of the first \$5000 = \$1000

30 per cent of the next \$5000 = \$1500

How much income has John left to spend or save after tax? The answer is \$7500. This is called the taxpayer's disposable income. John can now 'dispose' of it (spend it or save it) as he chooses.

Tips for success

When a question asks about the impact of tax or interest rate changes on a business, always refer to the type of good or service the business produces.

Activity 26.2

Here are eight products:

- bread
- petrol
- TVs
- foreign holidays
- cooking oil
- jewellery
- salt
- home computers.

The sales of four of these products are likely to fall following an increase in income tax rates. Sales of the other four will not be much affected. Identify the four products likely to be most affected.

Profits tax (or corporation tax)

This is a tax on the profits made by businesses – usually companies.

How would an increase in the rate of corporation tax affect businesses? There would be two main effects.

- Businesses would have lower profits after tax. Managers will therefore have less money or finance to put back into the business. The business will find it more difficult to expand. New projects, such as additional factories or shops, may have to be cancelled.
- Lower profits after tax is also bad news for the owners of the business. There will be less money to pay back to the owners who originally invested in the business. Fewer people will want to start their own business if they consider that the government will take a large share of any profits made. Companies' share prices could fall.

Indirect taxes

Indirect taxes, such as Value Added Tax (VAT), are added to the prices of the products we all buy. They obviously make goods and services more expensive for consumers. Governments often avoid putting these taxes on really essential items, such as food, because this would be considered unfair, especially to poorer consumers.

How would businesses be affected by an increase in an expenditure tax? Again, there would be two main effects.

- Prices of goods in the shops would rise. Consumers may buy fewer items as a result. This will reduce the demand for products made by businesses. Not all businesses will be affected in the same way, however. If consumers need to buy a product such as a new battery for their alarm clock, then the price increase is unlikely to stop them from doing so. However, they might buy fewer ice creams as their prices have risen and they are hardly essential to anyone!
- As prices rise so the workers employed by a firm notice that their wages buy less in the shops. It is said that their real incomes have declined. Businesses may be under pressure to raise wages, which will force up the costs of making products.

Import tariffs and quotas

Many governments try to reduce the import of products from other countries by putting special taxes on them. These are called **import tariffs** and they raise money for the government. Many international organisations, such as the World Trade Organisation, are trying to reduce the number of governments which do this.

How would businesses in a country be affected if the government put tariffs on imports into the country? There are three possible effects.

- Firms will benefit if they are competing with imported goods. These will now become more expensive, leading to an increase in sales of home-produced goods.
- Businesses will have higher costs if they have to import raw materials or components for their own factories. These will now be more expensive.
- Other countries may now take the same action and introduce import tariffs too. This is called retaliation. A business trying to export to these countries will probably sell fewer goods than before.

Another method a government can use to limit imports is to introduce an **import quota** or physical limit on the quantity of a product that can be brought in. Quotas can be used selectively to protect certain industries from foreign competition that may be seen as unfair or damaging to jobs.

Changes in government spending

Governments in most countries spend the tax revenue they receive on programmes such as:

- education
- health
- defence
- law and order
- transport – roads and railways.

When governments want to boost economic growth, they can increase their spending on these programmes. This will create more demand in the economy, more jobs and GDP will increase.

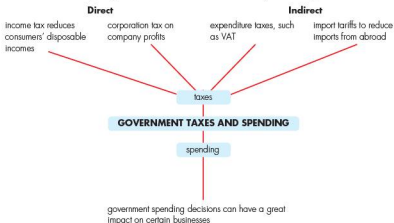
If governments want to save money – if they have over-borrowed for example – they will often cut government spending. These cuts could have a considerable impact on businesses which, for example:

- produce equipment for schools and hospitals and defence equipment
- build roads, bridges and railways.

Definitions to learn

An **import tariff** is a tax on an imported product.
An **import quota** is a physical limit to the quantity of a product that can be imported.

Revision summary: government taxes and spending



Definitions to learn

Monetary policy is a change in interest rates by the government or central bank, for example the European Central Bank.

Definitions to learn

Exchange rate appreciation is the rise in the value of a currency compared to other currencies.

Monetary policy – interest rates

An interest rate is the cost of borrowing money. In most countries, the level of interest rates is fixed by the government or the central bank via **monetary policy**. In some societies, the charging and the payment of interest is against the customs and traditions of the population. In most countries, however, businesses and individuals can borrow money, from a bank for example, and they will have to pay interest on the loan.

The following are likely to be the main effects of higher interest rates.

- Firms with existing variable interest loans may have to pay more in interest to the banks. This will reduce their profits. Lower profits mean less is available to distribute to the owners and less is retained for business expansion.
- Managers thinking about borrowing money to expand their business may delay their decision. New investment in business activity will be reduced. Fewer new factories and offices will be built. Entrepreneurs hoping to start a new business may not now be able to afford to borrow the capital needed.
- If consumers have taken out loans such as mortgages to buy their houses, then the higher interest payments will reduce their available income. Demand for all goods and services could fall as consumers have less money to spend.
- In addition to the point above, if the business makes expensive consumer items like cars or if they build houses then they will notice that consumer demand will fall for another reason. Consumers will be unwilling to borrow money to buy these expensive items if interest rates are higher. These businesses may have to reduce output and make workers redundant.
- Higher interest rates in one country will encourage foreign banks and individuals to deposit their capital in that country. They will be able to earn higher rates of interest on their capital. By switching their money into this country's currency they are increasing the demand for it. The exchange rate will rise – this is called **exchange rate appreciation**. This will have the effect of making imported goods

appear cheaper and exports will now be more expensive. The opposite effect, if the exchange rate of a currency declines, is called an exchange rate depreciation.

Revision summary: interest rates



Supply side policies

In recent years many governments have tried to make the economy of their country more efficient. They aim to increase the competitiveness of their industries against those from other countries. This would allow their businesses to expand, produce more and employ more workers. Some of the policies which have been used to achieve these aims are listed below – they are called supply side policies because they are trying to improve the efficient supply of goods and services.

- *Privatisation* – privatisation is now very common. The aim is to use the profit motive to improve business efficiency.
- *Improve training and education* – governments plan to improve the skills of the country's workers. This is particularly important in those industries such as computer software which are often very short of skilled staff.
- *Increase competition in all industries* – this may be done by reducing government controls over industry or by acting against monopolies.

Activity 26.3: Impact of economic policies

You are the Managing Director of the largest computer manufacturing company in your country. Your business sells products at home and in foreign markets. Materials are imported from abroad. You employ hundreds of skilled workers to develop, assemble and test the computers. Your business is planning a major expansion programme.

The government of your country has recently announced the following policies. Explain the likely impact of each of these policies on your business:

- a reduction in income tax rates on high income earners
- lower corporation tax rates
- higher import tariffs on all imports
- higher interest rates
- higher expenditure taxes on luxury goods
- new training colleges to increase the supply of qualified workers
- strict controls on monopoly businesses to encourage new businesses to be formed.

Revision summary: government economic policies



Case study – Spanish people protest over economic policies



Huge protests have taken place in Spain as people and business leaders voice their worries over the government's economic policies.

The Spanish Government's finances are deeply in debt so it is having to cut government spending and increase direct and indirect taxes. The country's GDP fell last year and is expected to decline again in 2013. Living standards are falling – especially amongst the growing numbers of unemployed. About 23 per cent of the total workforce are now unemployed.

Activity 26.4

Read the case study above.

- Explain what is meant by 'the country's GDP fell last year'.
- Explain how falling living standards could affect:
 - a farm producing milk
 - a manufacturer of luxury leather goods.
- Identify and explain two reasons why the Spanish government might aim to reduce the level of unemployment.

How business might react to changes in economic policy

The following table explains how businesses might react to some major changes in government economic policy. The business decisions and effects could be reversed if the government decided to reduce taxes or interest rates.

| Government policy change | Possible business decision | Problems with this decision |
|---|---|---|
| Increase income tax – this reduces the amount consumers have to spend | Lower prices on existing products to increase demand Produce ‘cheaper’ products to allow for lower prices | Less profit will be made on each item sold (reduces gross profit margin) The brand image of a product might be damaged by using cheaper versions of it |
| Increase tariffs on imports | Focus more on the domestic market as locally produced goods now seem cheaper Switch from buying imported materials and components to locally produced ones | It might still be more profitable to export Foreign materials and components might be of higher quality |
| Increase interest rates | Reduce investment so future growth will be less Develop cheaper products that consumers will be better able to afford Sell assets for cash to reduce existing loans | Other companies might still grow so market share will be lost Depends on the product but could consumers start to think that the quality and brand image are lower? The assets might be needed for future expansion |

You will notice that all of these business decisions could have both negative and positive effects. The overall impact of these decisions may depend on:

- how big the changes are in government policy
- what actions competitors take in response to these policies.

International business in focus: Bangladesh motorbike industry ready to power ahead



The rapidly developing motorbike industry in Bangladesh could win a significant portion of the growing Asian market. Major stakeholders in the industry – manufacturers, component importers and dealers – want government policy action to help encourage local motorbike assembly. In particular they want:

- import tariffs on complete motorbikes
- more government spending on roads and other infrastructure
- low profits tax on small firms.

China currently dominates Asian motorbike production with around 50 per cent market share out of the total annual sales of 17 million units (2012). Demand from most Asian countries is growing as economies continue to benefit from growth and rising incomes.

Discussion points

- Why is the demand for motorbikes growing in Asia as local economies continue to grow?
- Explain how each of the government policy measures being demanded would benefit the Bangladesh motorbike industry.

Exam-style questions – Paper 1

- 1 The economy of Country A is growing rapidly. Unemployment is falling and the incomes of most consumers are rising. However, inflation increased to 8 per cent last year. Many business owners are worried that the government could increase interest rates.
- a) What is meant by 'inflation'? [2]
 - b) Identify **two** likely economic objectives of the Government of Country A. [2]
 - c) Identify and explain **two** types of taxes that a government can use to raise revenue. [4]
 - d) Identify and explain **two** ways in which an increase in interest rates could affect businesses in Country A. [6]
 - e) Do you think all businesses within a country benefit when the economy grows? Justify your answer. [6]
- 2 The Government in Country B is planning to increase taxes. It will use the revenue raised to build more roads and airports in an attempt to reduce unemployment and increase economic growth. The rate of inflation was very high last year but it has now started to fall. ADC produce exclusive branded fashion goods. Managers within ADC are planning to respond to the government policy of higher taxes.
- a) What is meant by 'economic growth'? [2]
 - b) Identify **two** effects on business of increased unemployment. [2]
 - c) Identify and explain **two** effects on businesses of high inflation. [4]
 - d) Identify and explain **two** ways in which a business producing luxury products could respond to higher taxes. [6]
 - e) Do you think that increased government spending on more roads and airports is a good idea? Justify your answer. [6]
-

Revision checklist

In this chapter you have learned:

- to explain the economic objectives of governments
- to understand the business cycle
- to understand the different types of government economic policy
- to explain the ways in which business activity might be affected by government economic decisions and how businesses might respond.

NOW – test your understanding with the revision questions on the CD-ROM.

This chapter will explain:

- how business activity can affect the environment and the concept of externalities
- what sustainable development means and how businesses can contribute to this
- how increasing concern for the environment and pressure groups are influencing business decisions
- how legal controls can be used to influence business decisions to protect the environment
- how ethical issues might affect business decisions.

Business activity and the environment

Consider these two statements by different factory managers:

- **Manager A:** 'I know that my factory pollutes the air and the river with waste products but it is very expensive to use cleaner methods. We make a profit from making cheap products and these are what consumers want.'
- **Manager B:** 'We recently spent \$10 million on new low energy boilers that produce 90 per cent less pollution than the old ones. We now recycle 75 per cent of our waste – consumers prefer firms that are aware of their **social responsibility**.'

Business activity aims to satisfy customers' demand for goods and services – but it often has an impact on the **environment**. The 'environment' means our natural world.

Here are some examples of how business activity impacts on the environment:

- Aircraft jet engine **emissions** damage the atmosphere.
- **Pollution** from factory chimneys reduces air quality.
- **Waste disposal** can pollute rivers and seas.
- **Transport of goods** by ship and trucks burns fossil fuels such as oil which create carbon emissions and may be linked to 'global warming' and climate change.

Do these negative impacts on the natural environment matter? Many people believe they do – but other people think that all business should be worried about is satisfying customer demand as cheaply as possible.

Did you find yourself agreeing with one of the two managers above? Whether businesses should be concerned about environmental issues is a major current argument. Which side do you come down on?

Definitions to learn

Social responsibility is when a business decision benefits stakeholders other than shareholders, for example, a decision to protect the environment by reducing pollution by using the latest and 'greenest' production equipment.

Environment is our natural world including, for example, pure air, clean water and undeveloped countryside.



Air pollution damages the environment



Dirty rivers are expensive to clean up



Road transport creates noise and air pollution and adds to global warming

Tips for success

You must make sure you understand what 'socially responsible' means. Be prepared to discuss whether a business should be more socially responsible or not.

Let's look at both sides of the argument:

| Argument A: Business should produce goods and services profitably and not worry about the environment | Argument B: Businesses have a social responsibility towards the environment and this can benefit them too |
|---|---|
| Protecting the environment can be expensive. Reducing waste, recycling waste and reducing polluting smoke all cost businesses money and this reduces profits. | Global warming and global pollution affect us all and businesses have a social responsibility to reduce these problems. |
| Firms might have to increase prices to pay for 'environmentally friendly' policies. | Using scarce natural resources which are non-renewable, such as rainforest timber, leaves less for future generations and raises prices. |
| This could make firms uncompetitive and they could lose sales to businesses, perhaps in other countries, that are not environmentally friendly. | Most scientists and environmentalists believe that business activity can damage the environment permanently. |
| Consumers will buy less if they have to pay higher prices. | Consumers are becoming more socially aware – they are increasingly demanding products from 'environmentally friendly' firms and this can become a marketing advantage |
| If pollution is a problem, then governments should pay to clean it up. | If business damages the environment, then pressure groups could take action to harm the firm's reputation and sales. |
| Some business owners claim there is not enough proof that business activity is doing permanent damage to the environment. | |

Externalities

Most business activities – such as locating a factory or producing goods and services – lead to many different costs and benefits. It is important to distinguish between private costs and benefits and external costs and benefits. The following case study explains these differences.

Definitions to learn

Private costs of an activity are the costs paid for by business.

Private benefits of an activity are the gains to a business.

Case study – chemical firm expands

A chemical firm plans to open a new chemical factory. It has chosen a site which it believes is the most profitable one. In coming to this decision, the managers considered only the costs and benefits to the firm itself. These are called the **private costs** and **private benefits**. These are likely to be:

| Private costs | Private benefits |
|---|---|
| Cost of land | The money made from the sale of the chemical products |
| Cost of construction | |
| Labour costs | |
| Costs of running the plant when it has been built | |
| Transport costs of materials and completed products | |

Unfortunately, the site chosen is near a housing estate. It is currently part of a park used by local residents. Waste products from the factory will be tipped into local rivers or quarries.

(continued)

Definitions to learn

External costs are costs paid for by the rest of society, other than the business, as a result of business activity.

External benefits are the gains to the rest of society, other than the business, resulting from business activity.

Social costs = external costs + private costs.

Social benefits = external benefits + private benefits.

The factory will create a lot of noise and fumes. The area is one with a high level of unemployment – people's incomes are below the national average.

Before deciding whether or not to grant planning permission the government also considers the **external costs** and **external benefits** – that is, the impact on the rest of society other than the business itself.

| External costs | External benefits |
|--|---|
| Waste products will cause pollution | Jobs will be created |
| Smoke and fumes may damage the health of residents | Other firms may move into the area to provide services to the chemical firm |
| Parkland cannot now be used by local residents | The chemical factory will pay taxes – government might increase spending on social projects e.g. more hospitals |

The government will try to give a value to all of these costs and benefits. This is called cost-benefit analysis. This is not easy to do. For example, what is the cost of losing parkland for children to play on? Estimates are made and then the total costs and benefits of the decision are added up:

- private costs, added to external costs, give a total **social cost**
- private benefits, added to external benefits, give a total **social benefit** figure.

If the total social benefit is greater than the total social cost, the scheme is likely to be accepted. If, however, the total social cost is greater than the total social benefit, the government will probably refuse permission.

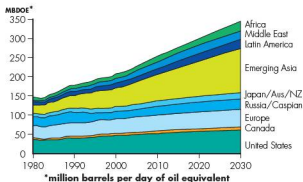
Activity 27.1

Read the case study above.

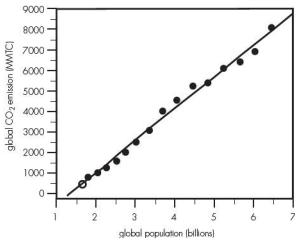
- What is meant by the term 'external costs'?
- Explain why any two stakeholder groups will be worried about the external costs from a new chemical factory.
- Explain why any two stakeholder groups will benefit from the possible external benefits from the new chemical factory.
- Assume you are the Government Minister responsible for planning decisions. Would you allow the new chemical factory to be built or not? Explain your answer.

Sustainable development

Look at the following information about the world's demand for energy and carbon dioxide emissions:



World energy demand



Global population and carbon dioxide emissions since 1900

Definitions to learn

Sustainable development is development which does not put at risk the living standards of future generations.

These graphs show some of the problems that world economic and population growth is resulting in. Many economists and environmentalists argue that this rapid rate of energy use and pollution cannot continue if the world is to enjoy the same living standards as we have today. Using up scarce resources at a very fast rate will mean that there may be many fewer resources in the future. Creating so much pollution may lead to health and climate problems that put at risk the wellbeing of millions of people.

Sustainable development means trying to achieve economic growth but without damaging the environment and society for future generations.

Sustainable development: what can business do?

- 1 Use **renewable energy** – by fitting solar panels or buying energy that uses renewable sources such as wind or tidal power.
- 2 **Recycle waste** – by re-using water and other products that would otherwise be wasted or disposed of, total use of resources is reduced.
- 3 Use **fewer resources** – lean production (see Chapter 17) is about managing production so efficiently that the minimum quantity of resources is used.
- 4 Develop new ‘**environmentally friendly**’ products and **production methods** – for example, replacing drink cans and bottles with biodegradable packaging that will not damage the environment.

Definitions to learn

Sustainable production methods are those that do minimum damage to the environment.

By using these sustainable production methods businesses respond positively to environmental pressures and opportunities.

Case study – Tunweni Drinks, Namibia

This company was the first in Namibia to adopt the country's Zero Emissions Research Initiative (ZERI). Examples of sustainable development initiatives at the Tunweni site are:

- Fibres from grain used in the production process are recycled and used in cultivating mushrooms.
- Methane gas is produced from waste using a biodigester – the gas is used as energy within the plant.
- Waste water is used to farm fish in a newly constructed pond.

'This makes our business much more sustainable and gives us a competitive edge' said the Chief Executive of Tunweni Drinks.

Activity 27.2

Read the case study above.

- a) What is meant by the term 'sustainable development'?
- b) Explain why the three initiatives taken by Tunweni Drinks make the business 'more sustainable'.
- c) Explain why the Chief Executive believes that the business now has a 'competitive edge'.

Responding to environmental pressures and opportunities

How can society make business give the environment a higher priority? There are three main ways.

Pressure groups

Bad publicity is bad news! If a firm is reported as destroying an important natural site or dumping waste in the sea, then many consumers will stop buying its products. An increasing proportion of consumers are becoming concerned about their environment. Firms obviously want to sell goods profitably. If sales of a product fall because consumers think it is harmful to nature, then the business may have to quickly change its products or its production methods.

Pressure groups are becoming increasingly powerful. They can take some very effective actions against businesses that are not socially responsible. Pressure groups such as Greenpeace and Earth First! have tried to block up firms' waste pipes or organise **consumer boycotts**.

Pressure group activity is likely to change business actions when:

- they have popular public support and receive much media coverage
- consumer boycotts result in much reduced sales for the firm
- the group is well organised and financed.

Pressure group activity is unlikely to result in a change in business actions when:

- what the firm is doing is unpopular but not illegal, such as testing drugs on animals
- the cost to the business of changing its methods is more than the possible cost of poor image and lost sales
- the firm sells to other businesses rather than to consumers – public pressure will be less effective.

Definitions to learn

A **pressure group** is made up of people who want to change business (or government) decisions and they take action such as organising consumer boycotts. A **consumer boycott** is when consumers decide not to buy products from businesses that do not act in a socially responsible way.

Laws passed by government

Governments can make business activities illegal. For example:

- locating in environmentally sensitive areas such as national parks
- dumping waste products into rivers or the sea – though it is sometimes difficult to prove which firm is responsible for this
- making products that cannot easily be recycled.



It is often difficult for governments to find out which firms are responsible for dumping chemical waste

Manufacturers often complain that these laws make it more expensive for them to produce. This raises prices to consumers. For this reason some governments do not pass strict laws on the environment, hoping that this will encourage firms to produce in their country to create jobs. Do you think it is socially responsible for a business to locate in a country that does not have strict laws on protecting the environment?

Financial penalties, including pollution permits

Pollution permits are licences to pollute up to a certain level. Governments can sell a permit to a factory that produces pollution. If it produces more pollution than the permit allows, it must either buy more permits from 'clean' firms or pay heavy fines. Either way, the costs of the business increase. Firms producing much less pollution can sell their permits to 'dirty' firms. This encourages firms to produce goods in less polluting ways. Other financial penalties could be additional taxes on goods or factories that create pollution.

These three types of controls help to explain why many businesses now respond to environmental pressures. Being 'environmentally friendly' can create a positive public opinion of a business and lead to opportunities for sustainable growth.

Case study example – should governments use laws to protect the environment?

In Country X, there are very few government controls on business activity. The Government of Country X wants to encourage businesses to start up and grow. A Government minister said that: 'Legal controls over pollution and disposal of waste add to business costs. This will discourage production in our country'. Country X sells many products, such as cars, clothing and chemicals in world markets at very low prices.

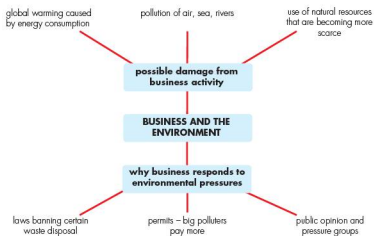
In Country Y, the Government has very strict laws to control the ways in which businesses dispose of their waste, how much pollution they can produce and where new factories are located. A minister in the Government said: 'We believe that businesses have a social responsibility to our community not to damage the environment. These laws have encouraged businesses to use much cleaner production methods. They have also developed products that pollute the environment much less than cheaper products. Many consumers in the world today will only buy 'environmentally friendly' products'.

Activity 27.3

Read the case study on page 334.

- What is meant by the term social responsibility?
- Identify and explain two reasons why the Government in Country X does not have strict controls on business activity that affects the environment.
- Identify and explain two ways in which business activity can damage the environment. Use examples from your own country.
- Do you think that the Government of Country Y is right to use strict laws against businesses that damage the environment? Justify your answer.

Revision summary: environmental constraints



Case study example – Acme Oil Company

For years Acme Oil Co. had been dumping waste products in the sea. The company argued that the dumping was far out at sea, and so it harmed no one. It was a much cheaper method of getting rid of the waste than buying equipment to treat the waste. Low costs helped the firm to keep down prices to consumers.

Environmental pressure groups had taken some action but it was ineffective. Then, one day, thousands of dead fish and sea birds started to be washed up on the east coast. After examination it was found that they contained dangerous levels of oil-based poisons. Acme Oil denied all responsibility and blamed a recent oil spill from another firm's tanker. Environmental pressure groups started to blockade Acme's petrol filling stations. They gained great support from the public. Acme's sales fell but they refused to change their policy. Foreign news reporters were following the story closely.

The Chief Executive was suddenly replaced and a press conference was announced for the following week. Perhaps the company was about to change its environmental policy after all?

Activity 27.4

Read the case study on page 335.

- Define the term pressure group.
- Why was Acme Oil unwilling to change its dumping policy after the fish and birds were washed ashore?
- Explain two reasons why pressure groups might be successful in changing the business's decision in this case.
- Do you think that Acme Oil should stop dumping waste and buy equipment to treat it? Give reasons for your answer.

Definitions to learn

Ethical decisions are based on a moral code. Sometimes referred to as 'doing the right thing'.

Ethical issues

Should businesses always 'do the right thing'? Should businesses always take decisions that are fair and moral?

Should businesses ever:

- take or offer bribes to government officials or people working for other firms, for example, to gain secret information?
- employ child workers, even though it might not be illegal in some countries?
- buy in supplies that have led to damage to the environment, for example wood obtained from cutting down rain forests?
- agree to 'fix high prices' with competitors?
- pay directors large bonuses and owners of businesses large profit payouts at the same time as reducing the workforce?

These are all examples of 'ethical decisions' that many businesses have to face up to very frequently. People can have very different answers to the questions above. This is because people have very different moral codes and therefore different ethical standards. The two most extreme views are:

- 'As long as a business does not deliberately break the law then any decision it makes is acceptable. Businesses want to make profits, after all'.
- Even if certain activities are not illegal, it is **unethical** and therefore wrong to do them despite any increase in profits that might occur.'

Impact on business of ethical decisions

Assume a large multinational clothing business – 'Company X' – bought clothes from a factory in a low-income country. The managers of Company X know that the factory employs child labour – it is not illegal to employ workers as young as 12 years old in the country it is based in.

Another business – Company Y – only buys clothes from suppliers who guarantee not to employ children and pay reasonable wages and offer good working conditions. Company Y managers check that suppliers keep to these standards. What is the potential impact on Country Y of this ethical decision?

Tips for success

Remember that there is no 'right or wrong' answer when discussing ethical decision making. Be prepared to discuss the impact on a business being less or more ethical in its decision making.

| Potential benefits of ethical decisions – Company Y | Potential limitations of ethical decisions – Company Y |
|---|---|
| Consumers may be against buying clothing products made by children and increase purchases from Company Y and reduce purchases from Company X | Higher costs – adult workers will be paid more than child workers and good working conditions add to business costs too |
| Good publicity about Company Y's ethical decisions will provide 'free promotion' – Company X may suffer from bad publicity | Company Y's prices might have to be set higher than those of Company X because of higher costs |
| Long-term profits of Company Y could increase | If consumers are only interested in low prices – and not how products are made – then sales of Company Y could fall |
| Some workers and investors may want to be linked to an 'ethical' business – Company Y may find it easier to recruit the best workers and raise capital. | Short-term profits of Company Y might fall |
| There is less risk of legal action being taken against Company Y | It could be argued that, in some countries, if children are not employed the incomes of their families will fall to very low levels |

Case study – directors paid 300 times more than workers!

The average executive in the US earns around 300 times more than the average worker in their companies. Many people believe that this pay gap is unacceptable and unethical. 'How is it fair that a director earns in one day what a worker takes a whole year to earn', is one criticism that is often heard. The Chief Executive of Whole Foods Inc. is an exception. He is paid just 19 times the average wage in his company. He claims that the great pay gap in other companies leads to low worker morale and loyalty. In addition many consumers feel that the prices they pay are too high because of excessive directors' salaries and bonuses. The Chief Executive of Kraft Inc., the multinational food company, recently had a 41 per cent increase in total annual pay – in the same year that the company made many of its employees in the UK redundant.

Many directors argue that it is essential to pay very high incomes to 'the best' managers so that the companies can be more successful in future. However, despite senior directors of banks in the US and Europe making decisions recently that led to huge losses and government bail-outs, they were still paid large bonuses! Is this an example of an unethical decision or not?

Source: theweekinethics.wordpress.com (5 April 2010)

Activity 27.5

Read the case study above.

- What is meant by 'an unethical decision'?
- Identify and explain two likely reasons why directors are paid more than workers in most companies.
- Is it right that directors can be paid up to 300 times more than average workers? Explain your answer by considering the advantages and disadvantages of this situation.

International business in focus: Airbus reduces environmental cost of air travel



Fuel-saving planes are popular with airlines

Airbus Industries, the world's largest manufacturer of passenger aircraft, is producing a new range of planes. These planes are more efficient than the existing models in order to save fuel – they are 20 per cent more economical. They are also much quieter than earlier models. Many airlines want to buy these planes even though they are expensive. The airlines will save fuel but also improve their image of 'social responsibility'.

Plane makers and airlines are worried by Greenpeace pressure group activity. This organisation claims that aircraft will cause 20 per cent of the world's air pollution by 2020. It is asking governments to put high taxes on aircraft fuel to make air travel more expensive. Airbus hope that the new range of planes will reduce the need for such taxes.

Discussion points

- Does all business activity lead to environmental damage?
- Why do businesses often want to seem to be 'socially responsible'?
- When should businesses respond to pressure from groups such as Greenpeace, do you think?

Exam-style questions – Paper 1

- 1 Jean-Luc is the Chief Executive of a furniture factory. He promotes his business as supporting 'sustainable development', as wood is better than plastic or metal for the environment. His company makes wooden furniture that is sold in many countries. Wood is bought from the cheapest sources – Jean-Luc thinks it comes from rainforests that are being cut down but he does not ask the suppliers about this. Furniture is transported by trucks and ships. Waste wood is burnt as this is cheaper than sending it for processing into other products. Air quality in Jean-Luc's country is very poor but the Government does not know which the major polluters are. Jean-Luc's business employs 200 workers.
- What is meant by 'sustainable development'? [2]
 - Identify **two** ways in which Jean-Luc's business impacts on the environment. [2]
 - Identify and explain **two** ways in which Jean-Luc's business might be encouraged to be more 'environmentally friendly'. [4]
 - Identify and explain **two** possible benefits to Jean-Luc's business of it becoming more 'environmentally friendly'. [6]
 - Do you think it is right for Jean-Luc to promote his business as a supporter of 'sustainable development'? Justify your answer. [6]
- 2 MST is a large steel making business. Sales and profits have fallen recently. The directors are under pressure from the owners to make the business much more profitable. One director has paid a bribe to a Government official to make sure MST gained a Government contract. MST has closed two steel works this year and opened a huge new works in a low-income country. Pollution controls are very weak in this country. Wages are low and some children are employed in the works – but in non-dangerous jobs. 'Profits must be increased as a priority' said Marie the Chief Executive of MST, 'ethical decisions can come later'.
- What is meant by 'ethical decisions'? [2]
 - Identify **two** ways in which MST could be said to be operating 'unethically'. [2]
 - Identify and explain **two** possible benefits to the company of operating in these ways. [4]
 - Identify and explain **two** possible limitations to MST caused by paying bribes and employing children. [6]
 - Do you agree with Marie when she said: 'profits must be increased as a priority, ethical decisions can come later'? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- how business activity can damage the environment and lead to externalities
- ways in which business can respond to the threats and opportunities of environmental issues such as aiming for 'sustainable development'
- the role of pressure groups in influencing business decisions
- what 'ethical decision making' means and why some businesses consider this important.

NOW – test your understanding with the revision questions on the CD-ROM.

Business and the international economy

This chapter will explain:

- how globalisation creates threats and opportunities for businesses
- what multinational businesses are and the benefits to a business of becoming a multinational
- the impact multinationals can have on the economies they operate in
- how exchange rate movements can have an impact on business decisions.

Definitions to learn

Globalisation is the term now widely used to describe increases in worldwide trade and movement of people and capital between countries.

Free trade agreements exist when countries agree to trade imports/exports with no barriers such as tariffs and quotas

Globalisation

In many ways the world is becoming one large market rather than a series of separate national markets. The same goods and services can be found in many countries throughout the world. Workers are finding it easier to move between countries and capital (finance) is also moving more freely from country to country. There are several reasons for this increase in global trade and movement of products, people and capital (**globalisation**).

- Increasing numbers of **free trade agreements** and economic unions between countries have reduced protection for industries. Consumers can purchase goods and services from other countries with few or no import controls such as tariffs.
- Improved and cheaper travel links and communications between all parts of the world have made it easier to transport products globally. In addition the internet allows easy price comparisons between goods from many countries. Online or e-commerce is allowing orders to be placed from anywhere in the world.
- Many 'emerging market countries' are industrialising very rapidly. Countries in SE Asia and China used to import many of the goods they needed. Now their own manufacturing industries are so strong they can export in large quantities – at very competitive prices.

Globalisation – opportunities and threats

Increasing free trade and the rising mobility of labour and capital (for example the growth of multinational corporations) is having many effects on businesses all over the globe. Some of these effects are positive – opportunities – and some are potentially negative – threats.

Globalisation: potential opportunities for businesses

| Opportunity | Impact on businesses |
|--|---|
| Start selling exports to other countries – opening up foreign markets | This increases potential sales, perhaps in countries with fast growing markets. Online selling allows orders for goods to be sent in from abroad |
| | but it can be expensive to sell abroad and will foreign consumers buy products, even if they were popular 'at home'? |
| Open factories/operations in other countries (become a multinational) | It could be cheaper to make some goods in other countries than 'at home' |
| | but will the quality be as good? Might there be an ethical issue (e.g. over poor working conditions)? It is expensive to set up operations in other countries |
| Import products from other countries to sell to customers in 'home' country | With no trade restrictions it could be profitable now to import goods and services from other countries and sell them domestically |
| | but the products will need maintenance and, perhaps, repairs – will the parts and support be available from the producer in the foreign country? |
| Import materials and components from other countries – but still produce final goods in 'home' country | It could be cheaper to purchase these supplies from other countries now that there is free trade – this will help to reduce costs. These supplies could be purchased 'online' |
| | but will the suppliers be reliable? Will the greater distance add too much to transport costs? |

Globalisation: potential threats to businesses

| Threat | Impact on businesses |
|--|---|
| Increasing imports into home market from foreign competitors | If these competitors offer cheaper products (or of higher quality) sales of local business might fall |
| | but the increased competition could force the local businesses to become more efficient |
| Increasing investment from multinationals to set up operations in home country | This will create further competition – and the multinational may have economies of scale and be able to afford the best employees |
| | but some local firms could become suppliers to these multinationals and their sales could increase |
| Employees may leave businesses that cannot pay the same or more than international competitors | In some professions, employees will now have more choice about where they work and for which business – businesses will have to make efforts to keep their best employees |
| | but this might encourage local businesses to use a range of motivational methods to keep their workers |

Globalisation has led to more choice and lower prices for consumers. It has forced businesses to look for ways of increasing efficiency. Inefficient producers have gone out of business. Many firms have merged with foreign businesses to make it easier to sell in foreign markets. This is one of the reasons behind the growth of multinational organisations.

This process of more and more free trade does lead to some problems. Many workers, often in the poorest countries, have lost their jobs owing to globalisation. Big foreign corporations can often produce goods more cheaply and efficiently, so other countries' workers lose out. As governments can no longer 'protect' their own industries against foreign competition, this process can lead to serious economic and social problems.

Why some governments introduce tariffs and quotas

In Chapter 26, import tariffs were explained as being one form of taxes that government can use to raise revenue. There is another important reason why governments might introduce tariffs and **quotas** on imports.

They are forms of **protectionism** – to protect domestic industries from competition that might otherwise close them down. Foreign competitors might be able to produce products much more cheaply and if they were allowed to import without any restriction then local firms might be forced out of business. This would reduce employment and incomes.

This is a simple argument to understand – **but** many economists believe it is wrong. They believe it is better to allow local consumers to buy imported goods as cheaply as possible (to increase their living standards) and for local businesses to produce and export goods and services in which they have a competitive advantage. In this way, living standards across the globe can be increased. This is the free trade argument.

Definitions to learn

An **import quota** is a restriction on the quantity of a product that can be imported.

Protectionism is when a government protects domestic firms from foreign competition using tariffs and quotas.

Case study – IBM takes advantage of globalisation

IBM is one of the largest corporations in the world, manufacturing and selling computer hardware and software. It has taken full advantage of the opportunities offered by globalisation. Not only are its products sold in nearly every country but it has invested in factories and other operations in many low-cost countries with skilled IT employees – such as Romania. Most of the computers that it assembles in the US use low-cost imported components. The company is well positioned to take advantage of growth in emerging market countries such as Brazil and Vietnam. However, IBM faces huge competition from newly developing computer businesses in China and India. IBM cannot ask the US government to protect its US market with tariffs because of free trade agreements.

Activity 28.1

Read the case study above.

- Identify and explain three benefits to IBM of globalisation.
- Identify and explain one potential risk to IBM from continued globalisation.

Definitions to learn

Multinational businesses are those with factories, production or service operations in more than one country. These are sometimes known as **transnational businesses**.

Multinational businesses

It is important to remember that a **multinational business** is not one which just sells goods in more than one country. To be called a multinational, a business must produce goods or services in more than one country.

Multinational businesses are some of the largest organisations in the world. They include:

- oil companies: Shell, BP, Exxon
- tobacco companies: British American Tobacco, Philip Morris
- car manufacturers: Nissan, General Motors.

Activity 28.2

Make a list of at least four businesses operating in your country which are multinational. You can check this list with your teacher or by contacting some businesses themselves. Ask which other countries they operate in.

Why do firms become multinational?

These are some of the reasons why firms become multinational organisations:

- to produce goods in countries with low costs, such as low wages. For example, most sports clothing is produced in SE Asia because wages are lower than in Europe
- to extract raw materials which the firm may need for production or refining. For example, crude oil from Saudi Arabia is needed to supply oil refineries in the US
- to produce goods nearer the market to reduce transport costs. For example, tiles and bricks are expensive to transport so the producer sets up a factory near the market in another country
- to avoid barriers to trade put up by countries to reduce the imports of goods. For example, sales of cars made in Japan are restricted in Europe. Japanese manufacturers now make cars in Europe too
- to expand into different market areas to spread risks. For example, if sales are falling in one country the business may move to another country where sales are rising
- to remain competitive with rival firms which may be expanding abroad.

So, there is no doubt that businesses gain from becoming multinational. But what is the impact on the countries they operate in? There are both advantages and disadvantages to the countries as a result of multinationals operating there.

Advantages of multinationals operating in a country

- Jobs are created, which reduces the level of unemployment.
- New investment in buildings and machinery increases output of goods and services in the country. New technology can benefit the country by bringing in new ideas and methods.
- Some of the extra output may be sold abroad, which will increase the exports of the country. Also, imports may be reduced as more goods are now made in the country.
- Taxes are paid by the multinationals, which increases the funds to the government.
- There is more product choice for consumers and more competition.

Disadvantages of multinationals operating in a country

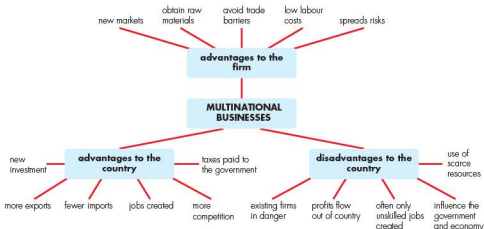
- The jobs created are often unskilled assembly-line tasks. Skilled jobs, such as those in research and design, are not usually created in the 'host' countries receiving the multinationals.

- Local firms may be forced out of business. Multinationals are often more efficient and have lower costs than local businesses.
- Repatriation of profits – profits are often sent back to a multinational’s ‘home’ country and not kept in the country where they are earned.
- Multinationals often use up scarce and non-renewable primary resources in the host country.
- As multinational businesses are very large they could have a lot of influence on both the government and the economy of the host country. They might ask the government for large grants to keep them operating in the country – threatening to leave the country with big job losses if these are not paid by the government.

Activity 28.3: Should we allow the XYZ Corporation to set up a factory in our country?

- The XYZ Corporation is applying for planning permission to build a factory in your country. The factory is expected to be very profitable. One thousand new jobs should be created for assembly-line work. Many of the goods made could be sold abroad. Some of the supplies for the factory will come from your country.
 - In your country unemployment is high, especially amongst skilled workers. The Government cannot afford any new building projects. There are several local competitors producing goods similar to the XYZ Corporation. Import levels are very high. Land for new building is very limited. New developments would have to be built in beautiful countryside.
- a) Identify three stakeholder groups in your country who may benefit from allowing the XYZ Corporation to build the factory.
- b) Identify three stakeholder groups in your country who may lose from the building of the factory.
- c) Would you advise your Government to allow the new factory to be built? Explain your answer by using all of the evidence.

Revision summary: advantages and disadvantages of multinational businesses



Exchange rates

Definitions to learn

The **exchange rate** is the price of one currency in terms of another, for example £1: \$1.5

If you have ever travelled abroad then you will know that it is usually necessary to change your money into foreign currency. Every country has its own currency and to be able to buy things in other countries you have to use the local currency. How much of another currency do you get in exchange for your own country's money? This will depend on the **exchange rate** between your currency and the foreign currency you wish to buy.

Assume that the exchange rate between the euro (€) and the US\$ is €1: \$1.5. This means that for each €1 being changed into dollars, \$1.5 would be received in exchange. In effect, this exchange rate is the price of one currency in terms of another.

How are exchange rates determined?

Most currencies are allowed to vary or float on the foreign exchange market according to the demand and supply of each currency. For example, if the demand for €s was greater than the demand for \$s, then the price of the € would rise. Compared to the exchange rate in the first example, the new rate might now be €1: \$1.75. Each € now buys more \$s than before.

How are businesses affected by changing exchange rates?

Changes in the exchange rate affect businesses in several different ways.

Exporting businesses

In the following case study example, consider the impact of changing exchange rates on an exporting business – one which sells goods and services abroad.

Case study example

Lion Trading Co. produces washing machines. The retail price of these machines is \$300. The company exports many machines to France and the price there has to be in euros (€). The current exchange rate is \$1: €1.6. The firm will therefore set a price of €480 for its machines in France (ignoring additional distribution and marketing costs).

Assume that the exchange rate for \$s now rises compared to the euro and \$1 is now worth €2. The Marketing Manager for Lion Trading now has two main options:

- to keep the price in France at €480 – this will mean that each machine is only earning the business \$240, not \$300 as previously
- to raise the price in France to €600 and continue to earn \$300 from each machine. This higher price in France could now lead to fewer sales and exports to France are likely to fall.

The change in the exchange rate described in the case study above is called a \$ **appreciation** because the value of the \$ has increased. Exporters have a serious problem when the currency of their country appreciates.

Case study example – exchange rate changes

A business currently sells men's coats for \$100. It also exports them to Japan. It sells them there for 8000 yen as the exchange rate is currently \$1: 80¥.

- The exchange rate for the \$ now appreciates to \$1: 100¥. The new ¥ selling price for the coats, assuming that the Marketing Manager wishes to earn the same amount of \$ from each coat will be: 10000¥.
- What might be the effect if the exchange rate for \$ fell? This is called a **depreciation**. The new ¥ price if \$1 falls to 60¥, assuming that the same amount of \$ is earned from each coat will now be: 6000¥.

Definitions to learn

Currency appreciation occurs when the value of a currency rises – it buys more of another currency than before.

Currency depreciation occurs when the value of a currency falls – it buys less of another currency.

Importing businesses

Now consider how an importing business – one which buys goods and services from abroad – might be affected by changing exchange rates.

Tips for success

Do not worry about exchange rate calculations – you will not be examined on these. But you will have to remember what happens to import and export prices when currencies appreciate or depreciate in value.

Case study

Nadir Imports Co. is based in the UK and buys fruit from other countries to sell to supermarkets. One tonne of bananas from abroad costs \$250 and at the current exchange rate of £1: \$2.5 this costs Nadir Imports £100.

If the value of the £ were now to depreciate what would happen to Nadir Imports' costs? Assume that the value of the £ now falls to £1: \$2, how much will a tonne of bananas now cost? The answer is £125, which is a substantial increase in costs for the importing firm.

Activity 28.4

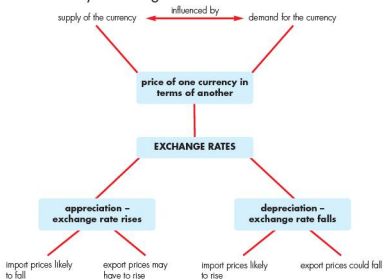
Read the case study above.

- Explain what would happen to the cost of Nadir's imports if the £ depreciated.
- Explain what would happen to the cost of Nadir's imports if the £ appreciated.

We have shown that an importing firm will have higher costs if the exchange rate of its currency depreciates, but will have lower costs if the exchange rate appreciates; whilst an exporting firm will be able to reduce its prices with a currency depreciation, but might have to raise prices with a currency appreciation.

You can now see how seriously businesses can be affected by exchange rate movements. This helps to explain why some international organisations such as the European Union (EU) have tried to reduce exchange rate movements. In the case of the EU, it has introduced a common currency (the euro) which removes the need for separate currencies and exchange rates between member countries.

Revision summary: exchange rates



International business in focus: Starbucks to change Argentina's café culture?



Since arriving in 2008, Starbucks has been opening new locations in Argentina at a rate of 12 per year. The company just opened the 36th location in Rosario, reflecting the shift of consumers in rural Argentina towards global brands. Starbucks new business plan aims to double the number of locations it opens in Argentina per year. Some people in Argentina have very mixed feelings about the growth of this huge multinational in their own country. A local newspaper listed some effects of this expansion:

Positives: 1) Starbucks employees here have an American customer service approach which is cheerful and helpful. 2) Your coffee is normally ready very quickly, and prepared using the correct method. 3) The opening of a Starbucks often leads to local competing cafés improving areas such as cleanliness, service, and pricing.

Negatives: 1) Buenos Aires has a deeply rooted traditional café culture, and Starbucks could threaten this. 2) They are practically identical to Starbucks everywhere in the world. 3) All major decisions, such as new investments, are taken outside of Argentina.

Discussion points

- Explain why Starbucks is referred to as a 'multinational'.
- Would you prefer to use a local café or one operated by Starbucks? Ask everyone in your class this question and see what the results are.
- On balance, do you think the expansion of Starbucks is good for countries such as Argentina?

Exam-style questions – Paper 1

- 1 PaintCo manufactures specialist paints for aircraft. It has taken advantage of globalisation. The research department recruits scientists from several countries. Until ten years ago it only had one large factory in Europe. Now PaintCo has four factories in low-cost countries. Raw materials are imported and the paints are exported to aircraft manufacturers in the US, Brazil and China.
- a) What is meant by 'globalisation'? [2]
 - b) Identify **two** reasons for increased globalisation. [2]
 - c) Identify and explain **two** possible threats from globalisation to PaintCo. [4]
 - d) Identify and explain **two** benefits of globalisation to PaintCo. [6]
 - e) Do you think PaintCo should build its next factory in Europe or in a low-cost country? Justify your answer. [6]
- 2 Beema is a successful business that makes shoes in Country B. It imports some of the leather and the machines it uses and exports 30 per cent of its output. Recently the currency of Country B has fallen in value (depreciated). Beema's managers are planning to open a second factory. This will be located in Country C which already has several shoe manufacturers. Country C has just agreed to stop using protectionism by removing trade barriers such as import tariffs. Many of its industries are inefficient.
- a) What is meant by 'exchange rate'? [2]
 - b) What is meant by 'exports'? [2]
 - c) Identify and explain **two** reasons why Beema is planning to become a multinational business. [4]
 - d) Identify and explain **two** effects on Beema of a depreciation of Country B's currency. [6]
 - e) Do you think the Government of Country C should encourage businesses such as Beema to start operations in its country? Justify your answer. [6]

Revision checklist

In this chapter you have learned:

- to explain what globalisation is and why it is important
- to explain why multinational businesses are created and understand the impact of them on the countries they operate in
- to understand what exchange rates are and how changes in them can affect businesses, especially importers and exporters.

NOW – test your understanding with the revision questions on the CD-ROM.

External influences on business activity: end of section case study (Paper 2 style)

FirstElectricity

FirstElectricity is a large company that generates electricity. The company has ten power stations which use coal and two power stations which use water to produce electricity. The directors of FirstElectricity are considering building a new power station near Main City.

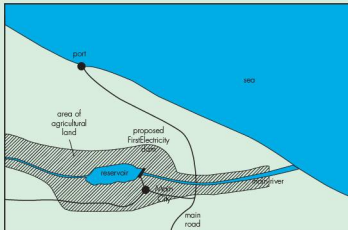
Main City is the capital of Country Z. It has been growing rapidly over the last five years as new businesses have set up and existing businesses have expanded. The population of the city also has grown as people from surrounding towns and villages have moved into Main City in search of jobs. Wages of skilled workers have been rising but unemployment for unskilled workers is high. The supply of electricity has become a problem with more and more power cuts occurring.

FirstElectricity is planning to build a dam across a wide river near the capital city if it gets permission from the Government. A dam blocks a river and creates a reservoir of water. Electricity is made as the water passes through the dam. This new power station would provide all the electricity needed by Main City and would be very profitable.



The reservoir behind the dam, if built, will be used by FirstElectricity to provide leisure facilities for people from Main City. They are considering having either the hire of rowing boats or swimming facilities in the reservoir.

Appendix 1



Map of the proposed area for the dam

Appendix 2

Extract from *Main City Times*, 3 November 2013

Will we benefit from the new power station?

Environmental groups have been protesting as FirstElectricity plans to build a dam over the country's wide river. If the dam is not built then the Government claims there will be more power cuts. Businesses may lose a lot of output and profit if they cannot manufacture products. Environmental groups claim the dam will destroy thousands of acres of excellent agricultural land and food supplies will be reduced. Food imports will increase and this will have a negative effect on Country Z's exchange rate.

Many people will be forced to leave their homes and move to another area. A Government spokesperson said the future growth of the country could be reduced if the dam is not built. Multinational companies may be put off locating in Country Z if the power station is not built.

- 1 a) Identify and explain **two** external costs and **two** external benefits of building the dam. [8]
- b) Do you think the Government should encourage the location of a multinational company in Country Z? Justify your answer. [12]
- 2 a) Identify and explain two effects on a business in Country Z if its exchange rate rises (appreciates). [8]
- b) FirstElectricity is considering offering bribes to government employees to get permission to build the dam. Is this right? Justify your answer. [12]

Optional questions

- 3 a) FirstElectricity will need to recruit construction workers to build the dam. Outline four stages of the recruitment and selection process FirstElectricity will need to follow to employ these workers. [8]
- b) Using all of the information available to you from the case study, consider the advantages and disadvantages of building the dam. Recommend whether the dam will be beneficial to Country Z. Justify your answer. [12]
- 4 a) Identify four stakeholder groups affected by the building of the dam. For each of the stakeholder groups identified in (i), explain how they would be affected by the building of the dam. [4]
- b) FirstElectricity plan to use the reservoir behind the dam to provide either the hire of rowing boats or swimming facilities for the people of Main City. Consider the advantages and disadvantages of primary research and secondary research to find out which activity will be the most popular. Recommend which research method they should use. Justify your choice. [12]

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